S. HRG. 99-575

THE NATIONAL CREDIT CARD CONSUMER PROTECTION ACT; AND THE CREDIT CARDHOLDER PROTECTION ACT

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

S. 1603

TO AMEND THE TRUTH IN LENDING ACT TO IMPOSE A NATIONAL CEILING ON CREDIT CARD INTEREST RATES

AND

S. 1922

TO AMEND THE TRUTH IN LENDING ACT TO IMPOSE A CEILING ON CREDIT CARD INTEREST RATES

JANUARY 28, 1986

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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THE NATIONAL CREDIT CARD CONSUMER PROTECTION ACT; AND THE CREDIT CARDHOLDER PROTECTION ACT

TUESDAY, JANUARY 28, 1986

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS,

Washington, DC.

The subcommittee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Slade Gorton (chairman of the subcommittee) presiding.

Present: Senators Gorton, Hecht, D'Amato, Proxmire, and Dodd.

OPENING STATEMENT OF SENATOR GORTON

Senator GORTON. Because of the great interest in this hearing and the large number of witnesses, we are going to begin immediately, and with a particular welcome to Senator D'Amato who is, of course, a member of the committee and who is greatly interested in the subject of this hearing; and an equally warm welcome for Senator Hawkins, whose arrival is imminent.

They are the sponsors of the two bills which are before this subcommittee today for hearing. It's been my privilege to serve with each of those Senators on this committee. Each has a strong record of support for consumer legislation and neither has ever shied away from a battle on behalf of his or her constituents. The people of Florida and New York can be proud to be represented by Senators with such strong proconsumer records.

We will be happy to have Senator Hawkins back. She was, of course, a member of this committee until we lost her to another last year.

Senator D'Amato, of course, is one of the most active members of the committee of all 15 members.

Today the subcommittee is considering two bills which propose to impose a Federal ceiling on credit card interest rates. There are few Members of Congress I know who are eager to impose such regulations. It's my experience that most Members, regardless of their place in the political spectrum, prefer to leave the determination of prices to the market and undertake proposals like this only with real reluctance.

For my own part, I think that the public generally is well-served by free and competitive markets provided that the competition is genuine and provided that consumers have the information and opportunity to make informed choices.

In recent months, however, there's been a growing suspicion in many minds that the credit card market may not be working as well as it might. Inflation has fallen dramatically, but the nominal charges in credit cards have stayed high, meaning that the real rates paid by consumers have skyrocketed.

Why has competition not brought rates down? Are rates at their current levels a normal phenomenon or are they an aberration caused by defects in the market? The number of cards issued and firms seeking to enter the market has risen dramatically suggesting the existence of attractive profits and showing at least an apparent real competition. Prices and terms offered by different issuers do vary enormously, suggesting to some the presence of healthy competition, but raising in other minds the question of why low-cost cards do not drive high-cost cards from the market.

My own inclination is first to seek to find ways to make the market work and only as a last resort to consider Federal regulation, but I do believe that the time is right for a close examination of this question and I look forward to hearing today's witnesses.

In addition to those who are here in person, several other groups have expressed an urgent desire to submit statements for the record and they will, of course, be accommodated.

Senator Proxmire, we're delighted to have you here.

Senator PROXMIRE. Thank you, Mr. Chairman. I have no statement.

Senator GORTON. At this point, since Senator D'Amato has a formal statement as a witness, we will skip him and go to Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. No statement.

Senator GORTON. At this point, Senator D'Amato, it's all yours.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Thank you very much, Mr. Chairman, and I commend you for calling this hearing and want to commend Senator Hawkins for her initiatives. Mr. Chairman, I'm going to ask that the full text of my statement be taken in the record as if read in its entirety.

Senator GORTON. Without objection.

Senator D'AMATO. In order to expedite this hearing I will refer to the charts that Senator Hawkins has had prepared.

[Charts supplied by Senator Hawkins follow:]

TOP CREDIT CARD LENDERS AND THEIR RATES

	Billions of Dollars	Interest Rate Percentage
Sears	11.62	21.0
Citicorp	4.38	19.8
Montgomery Ward	4.22	21.6
Bank of America	3.30	19.8
American Express	3.22	18.0
J.C. Penney	3.21	21.0
First of Chicago Bank	2.32	19.8
Chemical Bank	1.62	19.5
Chase Manhattan Bank	1.61	19.8
Manufacturers Bank	1.25	17.8 (as of 10/8/85)

Prime (%)	9.5
T-bills (%)	7.11
Discount (%)	7.5

Chart: Senate Republican Conference
Source: The Nilson Report, Company Representatives

TOP FIVE HOLDING COMPANIES IN FLORIDA

	Percentage Charge on Credit Card Interest
Barnett Bank	18
Sun Bank	18
Southeast Bank	18
Florida National	18
North Carolina National Bank	18

Prime Rate (%)	9.5
Six month T-bills (%)	7.11
Discount Rate (%)	7.5

Chart: Senate Republican Conference
(9/30/85)

Senator D'AMATO. Mr. Chairman, I've introduced S. 1922. I've introduced that bill to ensure that the financial institutions, that the banks of America, make a healthy profit, but let's also see to it that it does not go beyond what is healthy, that it does not border or become what we might term usurious. I believe that we have today a system characterized by a minimum amount of competition and indeed keeps consumers from getting an opportunity of receiving the best rates.

If one were to look at the charts of the 10 most widely used credit cards, you would find that the interest charged there is something in the area of 20-plus percent, although the average of interest rates charged on credit cards nationally is 18.6 percent. Let's look at that 18.6 percent.

It's interesting to note that back in 1982 when the cost of the money—the discount rate—was something in the area of 16 percent—that's the cost that the banks could borrow money at the cheapest—at that time the average credit card charges were in the area of 17.6 percent. So they had a 1½ point spread, plus their service charges, plus what they charged to the retailers, 4 percent.

Today the discount rate, the lowest cost for banks borrowing money, is 7.75 percent. It's below 8 percent. And yet we have for the 20 largest card issuers in America a rate of more than 20 percent. We have a national average, if you take in the financial institutions that have much lower rates, of 18.6 percent.

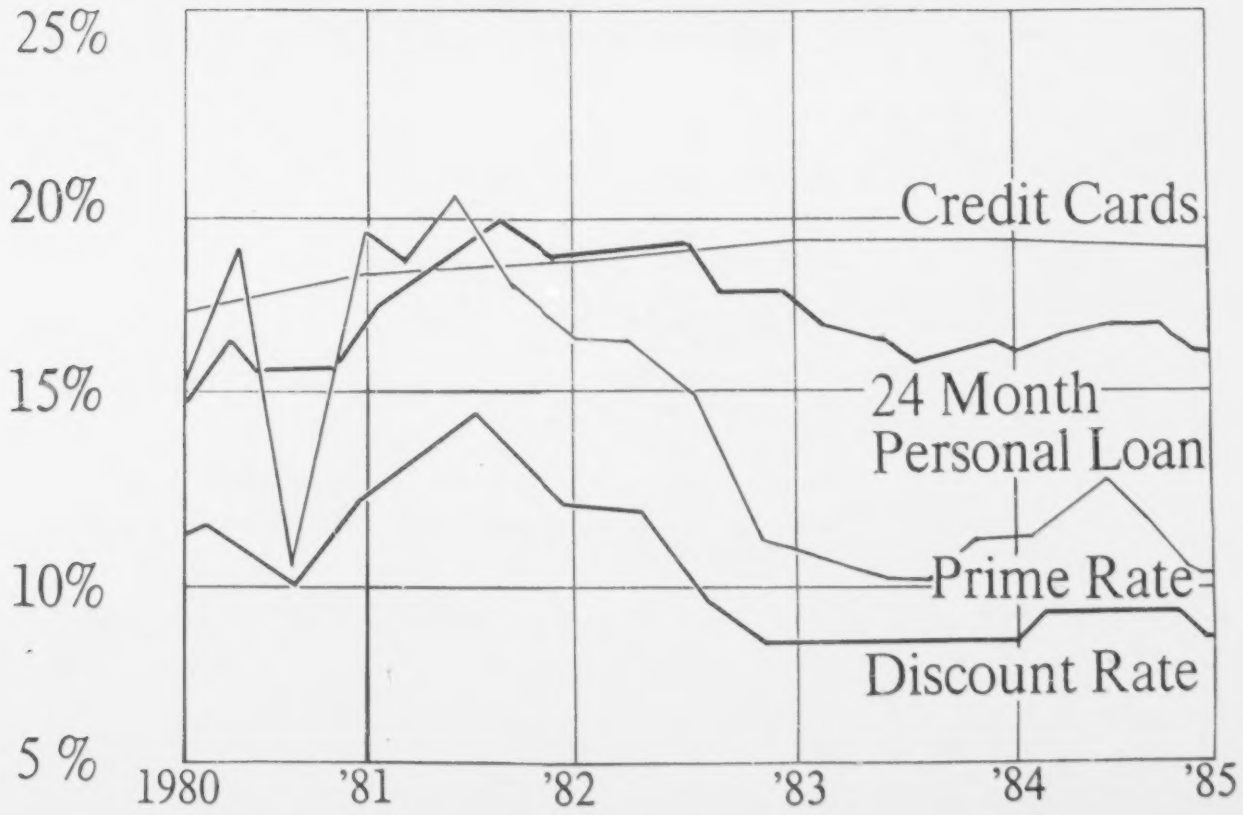
Well, where is that competition that the banks said if we deregulate, give us that opportunity, we'll give you competition. Let me tell you in New York where the competition was until recently. It was absolutely no place. We looked at the four largest money center banks and you find Chase Manhattan charging 19.8. We took Chemical Bank, 19.5; First National City Bank, 19.8; and up until several months ago, Manufacturers Hanover charged the same 19.8. I must report to you I'm very pleased that 2 months ago Manufacturers dropped their interest rate 2 percent down to 17.8 percent.

Now where could the consumers go? Where could they shop? Where could they get a better rate? By the way, how could they find out what the rates were? The fact of the matter is, I don't believe that those banks pegged those rates at 19.8, 19.8, 19.5 because competition led them there; it was a conspiracy of silence to put it there. After all, we're all doing well and we're making billions so why not engage in a form of legal usury. If the cost of money is 8 to 9 percent and you're loaning the money out at better than 20 percent and you get another 4 percent from merchants—and that's something that people don't know—4 percent for every transaction, that's what the merchant pays, we're talking about rates in some cases that are better than 24 percent.

Well, if that cost of money is 8 percent, that means that they're making a 200-percent profit, Mr. Chairman, and that's legal usury.

Now I know we want people to make a fair return so we've taken the average cost of money, the prime interest rate—the prime interest rate being that rate which gives a return and a profit and it's the money loaned to the best customer that you might have—that rate today is 10 percent. We've said let's take an average of the prime rate over 6 months. That's the Internal Revenue Service rate and

Interest Rates of Banks



see what that is, add 4 points to that, and so today the prime interest rate is 10 percent and if you add 4 percent to that that would give a 40-percent profit and on top of that there's the 4 percent that they generally get from the retailer, that's an 80-percent profit. If you can't make money with an 80-percent profit, then something is wrong. And if you're making more than that in terms of an 80-percent profit, then I think that the American public is being forced to pay billions of dollars unnecessarily. And if credit card practices don't screen out bad risks, the American public shouldn't be forced to pay for them.

Let me tell you what I did. Many people—and I think the Federal Reserve should be ashamed of itself for not requiring heretofore that the banks report the effective interest charges, and that's one of the things our legislation does, it requires monthly reporting of what the interest rate charges are so that the Federal Reserve can let people know that they can comparison shop.

We found out that there was a little bank down in Arkansas, Union National Bank. I don't own stock in it. To my knowledge, none of my family does. But I want to tell you something. The same VISA card and the same Master cards that any store will take, whether it's in New York, or Chicago, or Atlanta, or in Seattle, Mr. Chairman, and so you can make your purchases, and it's 12.5 percent. You've got to be crazy not to call them up—12.5. Why should you want to pay 20 or 21 percent?

I think that's the thing. Let's get some competition, some real competition, and I'll tell you—maybe we shouldn't do it, but there's a toll-free number. You can get the card just like I did. My secretary got it. I got it. That's a 1-800 number so you start out 1-800, a toll-free number. You can call and get these cards and you would be darn foolish—you'll see the way these guys will drop their rates if we begin to get the information out and you get some real competition. Otherwise, the barons are going to keep—I didn't say robber barons—but the barons will keep charging those same 20 percent rates. It's 1-800-351-9125. It might be the lowest rate in America. You've got to be silly not to call.

And you've got some other banks charging 13, 14, and you even have one, the Apple Bank in New York, charging 15 percent. So one of the parts of our legislation say that the banks have got to let the Federal Reserve know monthly what their charges are.

Now I know the talk about putting a ceiling on, that's going to hit a big stone wall where they say we don't want to regulate the cost of money and that will be difficult. But at the very, very least, Mr. Chairman, we should certainly see to it that we give people the opportunity to get the best rates and force these rates down because the American consumers are paying billions of dollars unnecessarily. And I applaud Senator Hawkins for her legislative initiative in this and I would hope, whether it's her bill or whether it's the bill that I put in, that this committee will come together to require complete disclosure. I think, by the way, 40-percent return on your money is pretty darned good, plus the 4 percent that they get from the store owners, plus the service fee that they get—some cards charge $40, $50, $60 for that. That's a pretty good return on investment, so I'm not giving up placing that 4 percent on top of

the prime interest rate. At the very least you start getting some competition in here and we'll see that those rates come down.

If you don't do it, if the American public doesn't do it well, they're going to keep those rates up there as high as they can to offset all those bad loans that they made to foreign nations. They don't like me saying that. So, until card issuers begin to act responsibly on their own volition or until legislation is passed requiring them to charge reasonable rates, I would advise consumers to shop around for the best rates or, better yet, to consider the advantages of leaving home without it.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

STATEMENT OF SENATOR ALFONSE M. D'AMATO

I appreciate the opportunity to discuss legislation regarding the reduction of unreasonably high credit card interest rates. I would have hoped credit card issuers would have acted responsibly and responded to market forces by voluntarily lowering their interest rates. The voluntary reduction on high interest rates would have obviated the need for this hearing. However, experience has taught us that once the genie of high interest rates has been let out of the bottle, voluntary reduction of interest rates is no more than wishful thinking. After waiting in vain for nearly 1 year for credit card interest rates to follow the decline of other interest rates, I think it is time we act. The legislation that we will discuss today, S. 1603, introduced by Senator Hawkins, and S. 1922, introduced by myself, represent attempts to compel credit card issuers to charge more realistic interest rates.

The question that we should address in this hearing should be: Why, in the current economic environment, have credit interest rates failed to respond to other market forces by remaining so high? I believe the answer is that credit card issuers have been unresponsive to the market forces that have driven the costs of other forms of credit lower. The legislation that I introduced compels credit card issuers to be responsive to market forces in the same manner in which State legislatures responded to the requests of card issuers to increase or remove usury ceilings when interest rates and inflation were skyrocketing several years ago.

When the prime rate rose to 20 percent and the rates earned on money market accounts peaked at 17 percent, many State legislatures raised, at the request of financial institutions, the rate ceiling credit card issuers could charge. During the last few years, the prime rate has dropped, the rates earned by depositors have dropped, the cost of funds to banks has dropped and interest rates charged by credit card issuers have not dropped. In fact, in certain instances, credit card interest has actually increased.

In the past, credit card issuers have claimed that interest rates have remained high due to the costs of servicing credit card charges. I find it hard to believe that servicing costs explain the failure of rates to fall. Servicing costs seem to be a particularly specious explanation since credit card issuers have been permitted to engage in certain practices so that interest rates could be kept low. For example, card issuers have been allowed to charge interest from the date of purchase, charge annual fees for all cardholders, and change their billing practices by sending summaries rather than receipts to their customers. If these actions were purportedly designed to maintain or reduce interest rates for customers, they certainly have failed. I would hate to see the rates that would be charged without these changes.

However, the credit card issuers have failed to fulfill their promise of lower rates that were to result from the changes in billing practices and the sharing of annual fees. Their failure to lower rates with the addition of these charges and changes in billing practices is further evidence of the unwillingness of card issuers to voluntarily lower their rates. If credit card rates were a function of the marketplace, then interest rates should have dropped in response to certain other factors that should have precipitated such a drop. However, it appears that credit card rates respond to the marketplace when rates are going up to the benefit of banks and not when rates should be dropping to the benefit of consumers.

Since credit card issuers have failed to lower interest rates, I was compelled to introduce the Credit Cardholder Protection Act, S. 1922, on December 11, 1985. The introduction of this bill is necessary because lowering these interest rates is essential to ensure that consumers pay credit card interest rates that are more in line

with the cost of money to banks. For example, in 1981, the cost of money was almost 16 percent and credit card rates were 18 percent. Today the cost of funds to banks is 7.5 to 7.75 percent and the average interest rate charged by the 10 largest card issuers exceeds 20 percent. Therefore, I believe that it is time to establish nationwide adjustable ceilings on credit card interest rates.

To ensure that consumers are protected from usurious credit card interest rates, the legislation that I introduced last month would force banks and other credit card issuers to charge interest rates that are reflective of prime rate and their cost of funds. Although a few banks have lowered their rates, and demonstrated that they can make a profit on credit cards with lower interest rates, for the most part, the banking industry has shown an unwillingness to lower their credit card interest rates on a voluntary basis.

I was initially reluctant to introduce the Credit Cardholder Protection Act because American consumers are, for the most part, well informed. They read labels carefully, shop at sales, buy more homes and cars when interest rates come down. But when it comes to that most basic or commodities, money, there is certain species that seems detached from reality: credit card man. They continue to pay an average interest rate of 18.6 percent, while the cost of financing purchases by credit card has rarely been higher, relative to other, sharply falling, interest rates and to inflation. Nonetheless, the Nation is on a credit card spending spree. Americans will charge $331 billion on their credit cards this year—up from $293 billion in 1984—and two-thirds of them will pay only a portion of their monthly bills, incurring high finance charges on the remainder. As a consequence of these charges, Americans have amassed a total outstanding credit card debt in excess of $110 billion.

The growing appetite of credit card man has helped consumer indebtedness reach a historic high and touched off a frantic scramble to sign up VISA and Mastercard customers. The furious competition, surprisingly, has not led to lower prices, as it has in such industries as long-distance telephone service. Only a few banks have lowered their credit card interest rates to attract new customers. Consumers have become addicted to credit, and, like other addicts, they don't seem to care about the cost of a fix. The reason that consumers seem insensitive to credit card interest rates is that they often are unaware of the existence of competition in interest rate charges. Moreover, credit card rates have stayed high because the marketplace is dominated by large banks that have tacitly chosen not to use lower interest rates as a way to compete with each other for customers. The Credit Cardholder Protection Act will foster competition by ending the conspiracy of silence surrounding the disclosure of credit card interest rates. The bill contains provisions that will enable consumers to access information regarding interest rates and shop for the best possible rates. For example, upon learning of the relatively low interest rate of 12.5 percent charged by the Union National Bank of Little Rock, AR, I applied for and recently was issued both a VISA and a Mastercard.

Consumer insensitivity to credit card interest rates will change due to hearings such as this and those that were conducted by the New York State Assembly and Senate earlier this month because credit card users are becoming more cognizant of the availability of cheaper credit, and the impact of usurious credit card rates on the cost, and availability of consumer credit. If consumers were to pay less in interest on their outstanding balances to the institutions that issue credit cards, then they would have more funds available to purchase additional goods.

For example, Americans were expected to spend nearly $25 billion on holiday merchandise this year. It was estimated that 60 percent of this merchandise will be paid for by credit cards. A lowering of these rates could save consumers millions of dollars in interest payments.

My remarks on this topic should not be misconstrued since I believe that if an individual purchases an item on credit, the creditor deserves to receive a reasonable amount of interest. My complaint against the issuers of credit cards is that they are taking undue advantage of card holders by charging unreasonable rates of interest in the current economic environment.

It seems unjustifiable and frankly incomprehensible that the interest rate charges by the institutions that issue credit cards have not reflected the steep declines in short-term interest rates experienced in other areas of commercial and consumer lending. I want to examine why banks and thrifts generally have not passed on the reduced cost of funds to their customers by lowering interest rates on credit card loans. The cost of money to these institutions, as measured by the discount rate they pay for money; is 7.5 percent and the prime lending rate is 9.5 percent but the average interest rate on credit cards is 18.6 percent. These facts demonstrate that the average rate charged to consumers has actually gone up while the cost of money has gone down. I am concerned about the reasons that credit card interest rates have

not fallen and the impact such high rates have on the American consumer and our economy in general.

Legislation has been introduced in both the Senate and House that will set a uniform standard for the interest rates the credit card issuers can charge. One legislative proposal sets the interest rate at 5 percent above the average yield of Treasury bills. Another proposal would set the rate at 6 percentage points above the 3-month Treasury bill rate. In studying the issue of what constitutes an appropriate rate I studied the difference between the interest rates that are charged and the rates credit card issuers pay for money to determine the reasonableness of interest charges. This examination culminated in the introduction of the Credit Cardholder Protection Act. This bill places a floating Federal cap on the interest rate that a credit card company can charge.

This legislation imposes a Federal ceiling on credit card interest rates at 4 points over the interest rate the Internal Revenue Service charges on late tax payments and pays itself on tardy refunds. The IRS rate is a compilation of prime interest rates from the previous 6 months and is recomputed every 6 months. The current IRS rate is 10 percent, making the legal cap on credit cards 14 percent. This reduction would save consumers over $1.16 billion a year. The rate dropped to 10 percent on January 1, 1986.

The use of the IRS rate has several advantages. This rate already has bank profit built in. Thus, the extra 4 percentage points built into the credit card interest rate cap I am proposing would provide for the cost and risks involved in issuing credit cards. The rate is subject to change only once every 6 months. Thus, while the interest rate will reflect fluctuations in the economy, it will provide consumers with sufficient stability to plan their budgets well in advance.

The second part of my bill requires full disclosure by the credit card companies. Currently, many credit card applications have little specific information pertaining to the interest that will be charged and the annual fees the cardholder will incur upon receiving the card.

Under my bill, all credit card applications will have to state the current interest charges and the annual fees charged for possessing the card. My bill will also require that these rates and fees be reported monthly to the Federal Reserve Board for publication.

Many consumers now are unaware of the rates they are being charged on their credit cards. Disclosure of this information on the initial credit card application will educate the consumer and, by using the publication which will be made available by the Federal Reserve Board, consumers will have the ability to comparison shop for the best credit card for their own individual needs.

In addition, my bill required the Federal Reserve Board's Consumer Advisory Council to submit yearly reports to Congress analyzing specific issues concerning the credit card industry. In particular, this panel will examine the impact the new interest rate cap will have on consumers and credit card companies.

Critics of this bill and others denounce them as unnecessary because the credit card industry is highly competitive and that high interest rates are justified because of the costs associated with developing complex technology and servicing customers. To them I respond: If the industry is so competitive why does so little variation exist in the interest rates charged by major card issuers? The answer is that while competition exists for market share, price competition is almost nonexistent. Moreover, the costs attributable to developing technology and servicing accounts seem inordinately expensive if these costs are the reason for excessive interest rate charges. In short, these so called facts cited to support excessive interest rate charges are nothing more than lame excuses offered to justify the legal usury inflicted on consumers by credit card issuers.

I realize there are several proposals currently being considered by the Congress. All of these bills establish alternatives to the present system, but I believe my bill is the most effective. It takes quick action—it does not wait for a study to initiate the action. The interest rate cap is based on a nationwide compilation of the prime rate and fluctuates only every 6 months, rather than monthly, providing a stable, understandable rate which reflects variations in the economy. And my bill will best inform the public as they comparison shop for the best credit card.

While studying this issue, I was recently encouraged by the decision of Manufacturers Hanover Trust Co. of New York to lower its interest rates 2 points from 19.8 percent to 17.8 percent. However, I was discouraged by reports that it was unlikely that other major credit card issuers would lower their rates. I do not understand their reluctance to lower their rates when the rates of certain types of consumer loans from a lending institution range from 13 percent to 16 percent or a credit union from 10 percent to 14 percent. I realize that there is an inherent risk that

credit card issuers are assuming since they may view their credit as largely uncollateralized, but does this fact alone require that they charge interest percentage points above the market rates? If certain individuals pose too great a risk to the credit card issuers, then credit should not be extended to them. It seems unfair to charge everyone the same high rates due to the fear that a small percentage will fail to pay off their balances.

While the specific cost of excessive rates to consumers is hard to determine it is clear that the consumer bears the burden of these excessive rates. According to Consumer Reports magazine, lenders receive $12 billion annually in interest rate collection assuming an average interest rate of 18 percent. If interest rates were lowered to the more reasonable figure of 15 percent, consumers would have to pay $9.4 billion in interest rates. Under the figures supplied by Consumer Reports, A 3-point lowering of rates could result in a $2 billion savings.

I am particularly concerned because credit cards are increasingly being used by middle-income Americans to finance essential goods and and not luxury items. In reality, the credit card provides many middle- and low-income Americans with a readily available and sometimes their sole source of consumer credit or interim financing. Credit cards used to purchase a broad range of essential consumer goods and services that include major appliances, hardward, clothing, food, medical, and legal expenses; and even college tuition.

The money saved from debt financing could have a dramatic and positive impact upon our economy that has been described by the experts as sluggish with low GNP growth. Thus, lowering credit card interest rates will have positive effects on the purchasing power of the average consumer and on the economy in general. The lowering of these excessive rates will have a positive effect on consumer, the employment rate, and the economy. Therefore, the Credit Cardholder Protection Act will increase the purchasing power of individual consumers and benefit the economy in general without unduly penalizing the lending institutions.

I believe that consumer awareness and the threat of legislation imposing a national ceiling would compel issuers to lower their rates is preferable to the imposition of a credit card ceiling. However, if the credit card industry is not a free market, then Congress should take appropriate steps to ensure that interest rates are fair. The Credit Cardholder Protection Act is designed to ensure interest rate fairness, permit credit card issuers to realize a reasonable profit, and prevent card issuers from being squeezed out of the market due to fluctuations in the cost of funds. The bill provides a flexible cap and fosters competition by establishing a maximum rate below which banks would compete rather than mandating a specific interest rate.

Until card issuers begin to act responsibly on their own volition or until legislation is passed requiring them to charge reasonable rates, I would advise consumers to shop around for the best rates or to consider the advantages of leaving home without it.

Credit Card Fact Sheet

I. The Consumer Federation of America estimates, on the basis of Federal Reserve data, that consumers are paying between $6 and $8.6 billion a year in interest on bank credit cards.

A reduction of the average interest rate from current levels to the 1980 level of 17.1 percent would save consumers between $550 million and $750 million a year.

II. According to the Consumer Federation of America's conservative estimate, 30 percent of the cost of credit cards is related to the cost of funds. The cost of funds has dropped by a third and this should result into a 10-percent reduction in credit card interest rates—a reduction of 1.8 percent to 2 percent.

III. Does competition really exist in an industry where the largest issuers charge approximately the same rate?

[Dollar amounts in billions]

	Interest rates (percent)	Amount outstanding on cards
Sears	21.0	$11.62
Citicorp	19.8	4.38
Montgomery Ward	21.6	4.22
American Express	21.0	3.22
J.C. Penney	21.0	3.21

[Dollar amounts in billions]

	Interest rates (percent)	Amount outstanding on cards
Bank of America	19.8	3.30
First National Bank of Chicago	19.8	2.32
Chase Manhattan	19.8	1.61
Chemical Bank	19.5	1.62
Manufacturers Hanover	17.8	1.25
By Contrast:		
Union National Bank (AR)	12.5	
Simmons First National (AR)	12 5	
Gem Savings Bank (Ohio)	13.0	
Chevy Chase S&L (MD)	14.0	
Republic Bank (TX)	14.5	

IV. Average rate of the 10 most frequently used credit card is 20.1 percent vs. the national average of 18.6 percent.

V. Comparison facts.

[Percent]

	Nov. 1981	Jan. 1986
Prime rate	17.5	9.5.
Discount rate	16	7.75.
Auto loans	17	12 and less (7.9 advertisements).
Average credit card rates	17	19.
Inflation	8.9	3 to 4

Senator GORTON. Thank you, Senator D'Amato.

Senator Hawkins, we welcome you back. We wish you were still here on a full-time basis, but we're happy that this bill has brought you here and we are anxious to hear what you have to say.

STATEMENT OF PAULA HAWKINS, U.S. SENATOR FROM THE STATE OF FLORIDA

Senator HAWKINS. Thank you, Mr. Chairman.

I think Senator D'Amato has waged a tremendous argument for some form of ceiling to fight the unfair gouging of the American consumers, and I am happy to participate in this long overdue discussion on current credit card interest rates.

This is an important national issue that affects millions of Americans nationwide and one that requires our immediate attention.

CREDIT CARDS ARE A NATIONAL FIXTURE

Since the beginning of the 1970's, the personal credit card has become a fixture in our economy. Senator D'Amato recommended you leave home without it. However, if you leave home without it you will not get a check cashed in most places.

Americans use a credit card for everything from school clothes for their kids to vacations in Florida. Most people prefer the convenience and safety of credit cards.

Yet even with the wide use of credit cards, recent facts demonstrate that credit card interest rates have not been competitive and do not respond to market changes. I believe that American consumers are still unaware that they can shop around for lower rates, and I feel some form of consumer protection is needed.

Let me review some interesting facts with this chart. In 1981, the prime rate was an all-time high of 20.5 percent, and the discount rate was 14 percent. At the same time, credit card interest rates had climbed to 17.78 percent.

Today, the prime rate has been cut in half and is now 9.5 percent. The discount rate is down to 7.5 percent. But credit card interest rates have actually gone up. They average between 18 and 22 percent, in addition to the annual membership fee. People would almost be much better off going to the local loan shark and saying, "I want to be your victim."

In spite of the fact that banks are now securing money at a reduced rate and are slashing prices for their best customers, they are collecting over $6 billion a year in interest on credit cards alone, in addition to the $3 billion in annual fees. Those are staggering figures!

By keeping credit card rates high while their own cost of money drops, banks have seemingly reaped a windfall. The disparity between rates is outrageous and unfair. The American consumer is being taken to the cleaners to the tune of $9 billion a year with no recourse but to keep paying or lose their credit.

The Miami Herald recently reported on the mixed results of this windfall. The newspaper told of one institution that mailed out more than 2 million unsolicited cards, then wrote off some $30 million in losses due to fraud or nonpayment. Who ultimately pays for these mistakes? The responsible card users. The relevant question raised by this example is: if the banks, as they claim, are not making any profit on their credit card operations and therefore cannot afford to voluntarily lower interest rates, how can they afford to engage in nondiscriminating practices like the one mentioned?

I believe this example justifies our curiosity and demonstrates that consumers need friends in the Senate to pay attention to their consumer interests. Any critics of any Federal legislation say we should leave this issue to the States, but, Mr. Chairman, the States have done very little to demonstrate that they are willing to protect their consumers. Only three States—Alaska, Arkansas, and Washington—have credit card interest rate ceilings below 18 percent and 17 States have no limit at all. What protection is afforded by an interest rate of 30 percent in New Jersey? And what protection is afforded the consumer when a large money bank moves its entire credit card operation from a State with a low ceiling to a State with no ceiling?

The threat of one State luring a credit card company away from another State will be fairly and uniformly prevented by Federal legislation.

PEG INTEREST RATES TO 6-MONTH T BILLS

I have introduced legislation in the Senate to alert American consumers to the disparities in credit card interest rates. My bill would amend the Truth-in-Lending Act and stipulates that the interest rates on credit cards may not exceed more than 5 percentage points beyond the average of the investment yield of 6-month U.S. Treasury bills which were outstanding the year before.

The average yield in 1983 was 9.27. In 1984, it was 10.43. If my bill had been enacted last year, the maximum interest rate that could be charged would be 15.43 percent, 5 percentage points above 10.43. This year, with T-bills averaging around 7.8 percent, a 5-point ceiling cap would limit the interest rate to under 13 percent, a rate that both consumers and banks can live with.

My bill pegs the interest rate to the 6-month T-bill because it is by far the best market indicator. Some believe the discount rate should be used as an index for setting ceilings on credit card rates. The discount rate, as you know, is the interest rate charged by the Federal Reserve Banks on extensions of short-term credit to depository institutions and is a tool of monetary policy. So it is an administered rate that reflects broad policy considerations and, therefore, is inadequate in credit card cap legislation.

Obviously, the banking community has responded negatively to legislative proposals to cap the interest rates on credit cards. The banks have the option of taking voluntary action, but most have not chosen this option.

Banks respond with some basic arguments. When faced with the figures that are demonstrated on chart I, the banks claim that the cost of funds, which have been cut in half in the past 5 years, are not a major determining factor in the credit card interest rate. However, even if the cost of funds represents only a small portion of the total cost of issuing credit cards, the fact remains that it has been cut in half. Rates have not come down even though some savings should have been achieved.

Second, the banks claim that interest rates are at their current level because they are recovering the losses that they sustained prior to 1980 when inflation was skyrocketing. If this is true, then it is simply an admission that interest rates are artificially controlled according to profit. This assertion undermines the claim that the cost of money is irrelevant to the credit card interest rates.

Others who are critical of this legislation maintain that there is strong competition in the credit card industry and that there is no need for legislation. However, I find no evidence to demonstrate that any real competition exists. Efforts to inform the consumer have been too slow in coming.

One should not assume that because there are a large number of providers of credit cards that there is competition. A large number of providers constitutes a necessary, but not sufficient, condition for a competitive market.

The fact is that few people know where to look for a credit card. They don't know that they can shop around and find lower rates. Rather they often simply take the card issued by their bank thinking that all cards are the same.

As Senator D'Amato has shown you, Simmons First National Bank of Pine Bluff, AR, charges 12.5 percent while most major banks are charging an average of 18.6 percent. If there was truly competition, wouldn't all of the banks charge a 12-percent rate in fear of losing their customers. It seems no one is afraid of losing customers because they know that consumers do not shop around. This is an issue that must be addressed.

Let me say to the subcommittee members that I would prefer that the banks voluntarily lower their rates, but since I introduced S. 1603 there's been very little movement in that direction. The second chart that I've displayed, Mr. Chairman, shows the rates charged by the largest banks in Florida. While they are all rather similar, 18 percent is still too high in today's market. Floridians deserve a better break—a greater choice of rates.

With the threat of legislation and widespread attention directed to this issue, I am happy to see that at least one major bank has responded. Manufacturers Hanover, which is the Nation's fifth largest card issuer, called my office shortly after I introduced my bill to tell me of a 2-percent reduction in their credit card interest rate.

That's the kind of reaction S. 1603 is intended to evoke. Hopefully, this is the beginning of an all-out credit card rate war. That is the kind of competition Americans deserve. Until I see justifiable rates, I will continue to fight this unfair gouging of consumers.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

PREPARED STATEMENT BY SENATOR PAULA HAWKINS

Since the beginning of the 1970's, the personal credit card has become a fixture in our economy. Today 75 percent of the families in the United States hold some type of credit card and as this trend continues our Nation will soon be on the verge of becoming a cashless society. Americans use credit cards to pay for everything from new school clothes for children to family vacations in Florida, with most people often preferring the convenience and safety of credit cards for every purchase they make. In fact, today it is virtually impossible to write a check without one.

Yet even with the wide use of credit cards by the American public, recent facts demonstrate that credit card interest rates have not been competitive and do not respond to market changes. Therefore, some form of consumer protection is needed, and now.

In 1981 the prime rate was at an all time high of 20.5 percent, and the discount rate was 14 percent. At the same time, credit card interest rates had climbed to 17.78 percent.

Today, the prime rate has been cut in half and is now 9.5 percent. The discount rate is down to 7.5 percent. But credit card interest rates have actually gone up. They average between 18 and 22 percent in addition to an annual membership fee. People would almost be better off going to a local loan shark.

In spite of the fact that banks are now securing money at a reduced rate and are slashing prices for their best customers, they are collecting over $6 billion dollars a year in interest on credit cards alone, in addition to the $3 billion dollars in annual fees.

By keeping credit card rates high while their own cost of money has dropped, banks have seemingly reaped a windfall. I believe that this disparity between rates is outrageous and unfair. The American consumer is being taken to the cleaners to the tune of $9 billion a year, with no recourse but to keep paying or lose credit.

The Miami Herald recently reported on the mixed results of this windfall. The newspaper told of one west coast institution that mailed out more than 2 million unsolicited cards, then wrote off some $30 million in losses due to fraud or nonpayment. Who ultimately pays for these mistakes? Obviously, it is the responsible card users.

The relevant question raised by this example is: If the banks, as they claim, are not making much profit on their credit card operations and therefore cannot afford to voluntarily lower interest rates, how can they afford to engage in nondiscriminating practices like the one mentioned? Obviously, this is a unique example, but I believe it justifies our curiosity on this issue and clearly demonstrates that the consumer needs a friend and information to protect their best interests.

Many critics of Federal legislation say that we should leave this issue to the States, but frankly, the States have done little to protect consumers. Only three States, Alaska, Arkansas, and Washington have credit card interest rate ceilings below 18 percent, and 17 States have no limit at all. What protection is afforded by an interest rate of 30 percent in New Jersey? And what protection is afforded the consumer when a large money bank moves its credit card operations from a State with a low ceiling to a State with no ceiling? The threat of one State luring a credit card company away from another State should be fairly and uniformly prevented. I have introduced legislation in the Senate, if for no other reason than to alert the American consumer to the disparities in credit card interest rates. My bill amends the Truth in Lending Act and provides that credit card interest rates may not exceed more than 5 percentage points above the average of the investment yield of 6-month U.S. Treasury bills which were outstanding the year before.

The average yield in 1983 was 9.27 percent. In 1984 it was 10.43 percent. If this bill had been enacted last year, the maximum interest rate that could be charged would be 15.43 percent—5 percentage points above 10.43. With T bill yields now around 7.8 percent, a 5 point cap would limit interest rates to under 13 percent, a rate that consumers and bankers both can live with.

My bill pegs the interest rate to 6-month T bill, because it is by far the best market indicator. I know that some believe the discount rate should be used as an index for setting ceilings on credit card rates. The discount rate is the interest rate charged by the Federal Reserve Banks on extensions of short-term credit to depository institutions, and is a tool of monetary policy. So, it is an administered rate that reflects broad policy considerations and therefore is inadequate in credit card cap legislation.

Obviously the banking community has responded negatively to legislative proposals to cap the interest rates on credit cards. But the banks have the option of taking voluntary action, which they have not done. They respond with some basic arguments. When faced with the figures that are demonstrated on chart 1, the banks claim that the cost of funds, which have been cut in half in the past 5 years, are not a major determining factor in the credit card interest rate. However, even if the cost of funds represents only a small portion of the total cost of issuing credit cards, the fact remains that it has been cut in half, and rates have not come down even though some savings should have been achieved.

Also, they claim that interest rates are at their current level because banks are recovering the losses that they sustained prior to 1980 when inflation was skyrocketing. If this is true then it is simply an admission that interest rates are artificially controlled according to profit. This assertion undermines the claim that the cost of money is irrelevant to the credit card interest rates.

Others who are critical of this legislation maintain that there is strong competition in the credit card industry, and that there is no need for legislation. However, there is absolutely no evidence to demonstrate that any real competition exists, efforts to inform the consumer have been too slow in coming.

One should not assume that because there are a large number of providers of this service that there is competition. A large number of providers constitutes a necessary, but not a sufficient condition for a competitive market. The fact is that few people know where to look for a credit card. They don't know that they can shop around, and find lower rates. Rather, they often simply take the card issued by their bank thinking that all cards are the same. But all cards are not the same.

Simmons First National Bank of Pine Bluff, AR, charges 12.5 percent while most major banks are charging an average of 18.6 percent. If there was truly competition, wouldn't all of the banks charge the 12-percent rate in fear of losing customers? The fact is, they don't fear losing customers, because they know that consumers do not shop around.

In my mind, this is an issue must be addressed. Let me say to the subcommittee members, that I would prefer that the banks take voluntary action, but since I introduced S. 1603, little movement in that direction has occurred.

The second chart before the subcommittee shows the rates charged by the largest Banks in Florida. While they are all rather similar, 18 percent is still too high in today's market. Floridians deserve a better break, a greater choice.

However, now, with the threat of legislation and widespread attention directed to this issue, I am pleased to see at least one major bank responding. Manufacturers Hanover, which is the Nation's fifth largest card issuer, called my office shortly after introducing this bill telling me of a 2 percent reduction in their credit card interest rate.

This is the kind of reaction S. 1603 is intended to evoke. Hopefully it will be the beginning of an all-out credit card rate war. That is the kind of competition Americans deserve. But, until I see these unjustifiable rates come down significantly, I will continue to fight this unfair gouging on the unassuming consumer.

[Copies of proposed bills, S. 1603 and S. 1922 follow:]

II

99TH CONGRESS
1ST SESSION

S. 1603

To amend the Truth in Lending Act to impose a national ceiling on credit card interest rates.

IN THE SENATE OF THE UNITED STATES

AUGUST 1 (legislative day, JULY 16), 1985

Mrs. HAWKINS introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To amend the Truth in Lending Act to impose a national ceiling on credit card interest rates.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "National Credit Card Consumer Protection Act".

SEC. 2. Section 107 of the Truth in Lending Act (15 U.S.C. 1606) is amended by adding at the end thereof the following:

"(f) The annual percentage rate which may be charged during a calendar year on an extension of credit obtained by use of a credit card may not exceed by more than 5 percent-

age points the average of the investment yield of United States Treasury bills with maturities of 26 weeks which were outstanding during the most recent 12-month period preceding January 1 of that year for which data are available, as determined by the Board.".

○

II

99TH CONGRESS
1ST SESSION

S. 1922

To amend the Truth in Lending Act to impose a ceiling on credit card interest rates.

IN THE SENATE OF THE UNITED STATES

DECEMBER 11 (legislative day, DECEMBER 9), 1985

Mr. D'AMATO introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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A BILL

To amend the Truth in Lending Act to impose a ceiling on credit card interest rates.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Credit Cardholder Protection Act".

SEC. 2. Section 107 of the Truth in Lending Act (15 U.S.C. 1606) is amended by adding at the end thereof the following:

"(f) The annual percentage rate applicable to an extension of credit obtained by use of a credit card may not exceed by more than 4 percentage points the rate established under

section 6621 of the Internal Revenue Code of 1954, as determined by the Board.".

SEC. 3. Section 127 of the Truth in Lending Act (15 U.S.C. 1637) is amended by adding at the end thereof the following:

"(c) A card issuer shall clearly and conspicuously disclose on initial applications for a credit card—

"(1) the annual percentage rate applicable to extensions of credit by means of that credit card or the means for determining that rate; and

"(2) any annual or other fee imposed for the issuance or use of that credit card.

Each card issuer shall report monthly to the Board for publication the average annual percentage rate and the amount of any annual or other fee applicable during the preceding month to its credit card accounts.".

SEC. 4. Section 703 (b) of the Equal Credit Opportunity Act (12 U.S.C. 1691b (b)) is amended—

(1) by inserting "(1)" after "(b)"; and

(2) by adding at the end thereof the following:

"(2) The Council shall transmit annually to the Congress a report that describes and analyzes the costs and risks involved in issuing credit cards, the percentage of credit card customers that have their cards revoked for non-payment or delinquent payments, revenues derived from interest rates

charged by credit card issuers, revenues derived from annual fees and application fees, and the impact that the provisions of section 107(f) of this Act will have on consumers and card issuers.".

○

Senator GORTON. Thank you, Senator Hawkins.

Is Governor Rice here? Would you come forward, please.

Senator PROXMIRE. Mr. Chairman, I have some questions for the two witnesses who testified from the chair. When will we get a chance to question them?

Senator GORTON. Senator Hawkins, are you going to stay?

Senator HAWKINS. Yes.

Senator GORTON. Let's hear from Governor Rice then and then we'll question all three of them together.

STATEMENT OF EMMETT J. RICE, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. RICE. Thank you, Mr. Chairman.

You have my prepared statement, I believe.

Senator GORTON. We do have your prepared statement and it will be included in the record as if read in full. We would appreciate you summarizing its salient points for us.

Mr. RICE. Well, I have a somewhat shorter summary, but it's not a great deal shorter.

Senator GORTON. Fine.

Mr. RICE. I appreciate the opportunity to appear before the subcommittee to present the views of the Federal Reserve Board on two legislative proposals that would establish nationwide floating ceilings on credit card interest rates, legislation that would supersede generally less restrictive State-imposed limits.

Recently a number of observers have noted that interest rates on bank credit card loans have edged up since the early 1980's even though market rates which represent costs of funding have fallen substantially. Some observers have concluded that the resistance of credit card rates to downward pressure indicates that credit card users have received inequitable treatment as compared with other borrowers.

OBSERVATION OF THE FED

Instead, the Board believes that the relative stability of credit card rates reflects the cost and revenue characteristics of credit card lending, plus State regulatory constraints on credit card rates.

Implicit in the notion that variations in credit card finance rates should correspond closely to changes in market rates is the assumption that the cost of funds is a dominant cost factor for suppliers of credit card services. In fact, the opposite is true. The cost of funds seems to be much less important for credit card operations than for most other types of lending.

But there is an even more striking difference between credit card loans and other types of lending. The key characteristic of revolving credit plans is that terms of repayment are quite flexible and repayments are largely at the discretion of the account holder. Excluding cash advances, which typically earn finance charges from the transaction date, most credit card plans charge interest only if cardholders pay less than the full amount of the outstanding balance by the end of the grace period.

There is evidence that some credit cardholders, perhaps nearly 10 percent at any one time, do not use their credit cards at all.

These nonusers generate no revenue from finance charges that would offset the costs incurred by card issuers in establishing and maintaining their accounts. However, many bank card issuers now charge cardholders an annual fee. Of cardholders who use their credit cards, some surveys indicate that roughly half usually pay off the entire balance when billed. Such cardholders produce no finance charge revenue to offset the costs of processing, billing, financing, although issuers of third-party credit cards derive some income from fees that merchants pay to help defray processing costs and, in many cases, from annual cardholder fees.

These considerations indicate that the behavior of credit card rates cannot be evaluated adequately simply by comparing them with the market rate of interest. A more meaningful measure is the net return to card issuers after deducting the cost of funds and other expenses. Surveys of commercial banks indicate that for most of the period from 1972 through 1984, in contrast to higher gross finance rates charged by banks on credit card indebtedness, average before-tax earnings have been substantially lower on bank credit card operations than on commercial or mortgage lending. These data do not support the view that credit card issuers have been able to take advantage of credit card borrowers.

But the fact remains that credit card rates have remained essentially unchanged, despite substantial variation in the cost of funds. Partly, as noted earlier, the stability of credit card rates reflects the lesser role of financing costs in the overall credit card cost function. It also reflects the impact of State-established statutory ceilings on interest rates.

In all but a few States, 18 percent per year was the upper limit on rates that card issuers could charge on credit card balances in the late 1970's when other interest rates were beginning to climb. Then, when market cost of funds rose sharply between 1979 and 1981 while credit card rates were restrained by the ceilings, net returns became negative on credit card plans at reporting banks. Many diversified creditors tightened their lending standards and deemphasized their credit card business. Some institutions stopped accepting new credit card accounts.

Now that credit card programs generally have become profitable again, many credit card issuers have intensified their efforts to market new credit card accounts and to encourage account usage. That is, credit card issuers in general have responded to falling cost of funding mainly by increasing the availability of credit cards rather than reducing financing rates. This move has helped to reverse the earlier curtailment of such credit that card issuers undertook as market rates moved up. Thus, it appears that much of the inertia in credit card rates has been attributable to the influence of restrictive rate ceilings imposed by States.

The factors on the demand side of the market, where credit card borrowing has been quite strong, also may have contributed to the observed stability of credit card rates.

The emergence of above average returns on bank credit card lending may not lead to an immediate widespread reduction in rates. Credit card issuers may be uncertain whether such favorable conditions will persist. Also, as noted earlier, instead of offering lower finance rates, card issuers may ease credit standards some-

what, provide more attractive nonrate credit terms, or offer other products and services. Even so, average finance rates on bank credit cards already have shown some tendency to decline.

REGULATORY MEASURES CAN BE COUNTERPRODUCTIVE

An effort to establish a federally mandated ceiling on credit card interest rates would likely encounter substantial difficulties. From experience with credit controls in 1980 and the sharp unexpected contraction in consumer spending that accompanied them, we know that regulatory measures can have unpredictable and unwanted consequences. The current ceiling for credit card rates under either of the proposed bills would be about 13 to 14 percent, well below rates that have been typical since credit cards emerged in the early 1960's as a major method of consumer financing.

Furthermore, the imposition of stringent rate ceilings might be countered by a tightening of nonrate credit card terms by card issuers. Some card issuers might also begin applying the reduced finance charges from the date of purchase, where permitted, rather than after the grace period expires, and might seek to raise merchant discount fees.

Turning to the specific provisions of the two bills, it should be emphasized that credit cards are issued by a broad variety of retail merchants and financial institutions that have different sources of funding and different liability structures. Under these circumstances, a single index rate as designated in each bill would be unlikely to mirror changes in costs for such a diverse array of card issuers.

Another question at issue is whether any regulation of credit card interest rates is more appropriately a matter for Federal or State intervention. In contrast to efforts at the Federal level to assure the safety and soundness of financial institutions, the establishment of interest rate ceilings on consumer loans has long been a State prerogative, one that the Board feels should not be preempted. Under the circumstances, the Board respects the collective judgment of a growing number of States that higher, not lower, ceilings are appropriate and notes that the States retain the authority to lower or restore ceilings if convincing evidence of excessive rate determination appeared.

In addition, there are certain other aspects of S. 1922 about which the Board would like to comment. Section III would amend the Truth in Lending Act to require that credit card issuers disclose on initial applications for credit cards the annual percentage rate to be charged and any annual or other fee imposed for issuing or using the credit card.

Certain credit card solicitations are already covered by current disclosure rules under Truth in Lending and the Federal Reserve Board's regulation Z. But if no cost information is contained in the mail solicitation, the card issuer is not now required to include truth in lending disclosures. In such cases, the proposed disclosure requirements probably would aid consumers in comparing offers to apply for particular credit card programs.

STUDY ON CLOSED-END CREDIT

Section III of S. 1922 also would require each credit card issuer to report to the Board on a monthly basis the average annual percentage rate and any annual or other fee applicable during the preceding month. In a related area, the Federal Reserve currently is analyzing the results of a study that is being conducted at the request of the Congress to measure the benefits of supplying consumers with comparative cost information about closed-end credit.

The findings from this project will provide a means of better evaluating the use that consumers make of published lists of comparative rate data in the process of obtaining credit. In view of the costs that would be associated with the collection and dissemination of comprehensive information about credit card interest rates and fees, the Board suggests that the Congress consider postponing any action in this area until the results of the demonstration project are available.

Senator D'AMATO. Mr. Rice, if I might, let me just—the last statement that you made that you're concerned about the costs attendant with them monthly giving you what the rates are so that the Federal Reserve can let that information go out to the people, that you want to make a study with respect to whether or not that is cost effective, is pure poppycock. That is nonsense. If that's the Board's position, I think it's irresponsible.

Senator PROXMIRE. Mr. Chairman, are we going to have an opportunity to ask questions in order or are we going to interrupt the witnesses?

Senator D'AMATO. Well, Mr. Chairman, I just made one observation. I don't think that's out of line, Bill.

Senator PROXMIRE. I do.

Senator D'AMATO. Well, I've heard you do that many times and I think my remarks were valid.

Senator GORTON. I think we should let the witness complete his statement.

Senator D'AMATO. And I wonder why you get so upset because I made one observation.

Senator GORTON. Senator, let's let the witness finish.

Senator D'AMATO. All right. You know, I'm not going to back off. It's not just one man who can do it.

Mr. RICE. Section IV of S. 1922 would direct the Consumer Advisory Council of the Federal Reserve Board to transmit a report to the Congress each year describing and analyzing several detailed aspects of credit card markets. As you may know, the Consumer Advisory Council is an independent advisory group that meets three times a year for 1½-day sessions to consult with the Board on various questions related to the Board's consumer financial protection responsibilities. The Council has no independent staff. Under the circumstances, the duties that would be assigned to the Council, requiring a substantial information gathering and analysis effort, would go well beyond the Council's capabilities and perhaps would even be inconsistent with its consultative nature.

In closing, I would like to reemphasize the Board's conviction that financial markets distribute credit most efficiently and productively when interest rates are determined in markets that are

as free from artificial restraints as possible. In the credit card business, the balance of the evidence suggests that revenues have stayed well in line with total costs, notwithstanding the minimal variation in finance rates. Furthermore, in recent months, there has been some tendency for credit card rates to decline. Efforts to constrain credit card rates through Federal regulation are likely to have undesirable side effects in the form of reduced credit availability, especially for those consumers that these bills would seek to aid. Moreover, they might encourage less efficient means of offsetting costs of credit card operations. Accordingly, the Board concludes that it would be inappropriate to impose a Federal ceiling on credit card rates. Thank you, Mr. Chairman.

[The complete prepared statement follows:]

For Release on Delivery
9:30 A.M., EST
January 28, 1986

Statement by

Emmett J. Rice

Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions and Consumer Affairs

of the

Committee on Banking, Housing, and Urban Affairs

United States Senate

January 28, 1986

I appreciate the opportunity to appear before the subcommittee to present the views of the Federal Reserve Board on two legislative proposals that would establish nationwide ceilings on credit card interest rates. One of these bills, S. 1603, would specify that the rate of interest on any credit card transaction could not be more than 5 percentage points higher than the average yield on 26-week Treasury bills during the preceding calendar year. The other bill, S. 1922, would limit the interest rate on credit card debt to 4 percentage points above the rate specified by the Internal Revenue Code for calculation of interest payable on overdue income tax payments or income tax refunds. The latter rate is essentially an average of the prime rate charged by commercial banks during a specified earlier six-month period.

Both bills under review today would set floating ceilings on credit card rates that would supersede generally less restrictive state-imposed limits. In the past, the Board has commented on similar proposals, including two bills currently pending in the House of Representatives. In doing so, it has endorsed the principle that--as with other types of credit--consumer loans are most fairly and efficiently allocated where there are no regulatory constraints on interest rates. Indeed, the Board has been concerned about the adverse impact that interest rate ceilings can have on the availability of funds in local credit markets and on individuals with limited access to credit. On frequent occasions, it has stated its opposition to such limits.

Recently, a number of observers have taken note that interest rates on bank credit card loans have edged up since the early 1980s even though market rates, which represent costs of funding, have fallen substantially.

Some of these observers have concluded that the resistance of credit card rates to downward pressure indicates that credit card users have received inequitable treatment as compared with other borrowers--a premise that underlies both bills. However, the Board believes that the relative stability of credit card interest rates reflects the particular cost and revenue characteristics of credit card lending, as well as state regulatory constraints on credit card rates, rather than any significant ability of lenders to take unfair advantage of credit card borrowers.

Implicit in the notion that variations in credit card finance rates should correspond closely to changes in market rates is the assumption that the cost of funds is a dominant cost factor for suppliers of credit card services. In fact, however, the cost of funds seems to be much less important in credit card lending than in most other types of credit. For credit card plans, the bulk of total costs is composed of operating costs incurred for processing transactions, making monthly billings, and evaluating credit applications, along with costs associated with delinquent accounts and credit losses. These cost factors vary in ways that usually differ from the pattern followed by changes in market costs of funds.

The Federal Reserve System each year surveys a number of commercial banks to obtain information about their costs of providing various services. From these average cost data, published under the title Functional Cost Analysis, the importance of financing costs and other costs can be compared for credit card operations and for other kinds of bank lending. During the period 1972 through 1984, financing costs averaged only about three-tenths of total expenses, before taxes, for the credit card function at participating medium- and large-sized banks that issue credit cards. By comparison, financing

costs at banks in the same size classes accounted for more than three-quarters of total costs of the commercial lending function, and for nearly nine-tenths of total costs of mortgage lending. Studies of credit card operations at retailers likewise have shown that funding costs are less important than operating and collection costs.

But there is an even more striking difference between credit card loans and other types of lending. The key characteristic of revolving credit plans is that terms of repayment are quite flexible and actual repayments in any given period are largely at the discretion of the account holder. Excluding cash advances, which typically earn finance charges from the transaction date, most credit card plans charge interest only if card holders pay less than the full amount of the outstanding balance by the end of the grace period. Thus, unlike other kinds of credit, the way the credit card holder uses the account determines how much--and, indeed, whether any--interest income is earned by the card issuer.

There is evidence that some credit card holders--perhaps nearly 10 percent at any one time--do not use their credit cards at all. These nonusers produce no revenue from finance charges that would offset costs incurred by card issuers in establishing and maintaining their accounts; however, many bank credit card issuers now charge card holders an annual fee. Of card holders who use their credit cards, some surveys indicate that roughly half usually pay off the entire balance when billed. Customers of this type also generate no finance charge revenue to offset costs of processing, financing, and billing; however, bank credit card issuers do derive some income from fees that merchants pay to help defray processing costs, and, in many cases, from annual card holder fees.

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These considerations indicate that the behavior of credit card rates cannot adequately be evaluated simply by comparing them with a market interest rate. Doing so would overlook fundamental differences in the behavior of costs and revenues between credit card operations and other types of lending--namely, that funding costs are a lower share of total costs for credit card lending, and that some credit card borrowers pay little interest, if any.

One measure that takes these differences into account is the net return to card issuers after deducting the cost of funds and other expenses. Again, the Functional Cost Analysis statistics for respondent banks provide some basis for comparison among types of lending. Data for the period 1972 through 1984 show that--in contrast to the higher gross finance rate charged by banks on credit card indebtedness--average earnings before taxes were substantially lower as a proportion of credit outstanding for bank credit card operations than they were for commercial or mortgage lending. These figures, of course, include periods of relatively low or negative net returns on credit card lending, such as in 1980, and periods such as 1984 when the net yield for the credit card function exceeded that for commercial loans and mortgage loans. Thus, the evidence suggests that, on average, credit card rates have remained well in line with costs as compared with other types of commercial bank lending. Accordingly, the data on the relative profitability of bank credit cards and other types of bank lending do not support the view that credit card issuers have been able to take advantage of credit card borrowers.

But while there is no reason to think that credit card rates have been unduly high on average over time, the fact remains that--in contrast to

other loan rates--credit card rates have remained essentially unchanged despite substantial variation in the cost of funds. Partly, as noted earlier, the relative stability of credit card rates reflects the lesser role of financing expense as a share of overall costs. However, it also reflects other special features of the credit card business. One of these is the existence of state-established statutory ceilings on interest rates.

In all but a few states, 18 percent per year was the upper limit on rates that card issuers could charge on credit card balances in the late 1970s when other interest rates were beginning to climb. Judging from the Functional Cost Analysis, average returns to banks on credit card operations in most prior years had been below or no higher than net earnings on other major forms of lending.

Then, when market costs of funds rose sharply between 1979 and 1981 while credit card rates were restrained by the ceilings, net returns became negative on credit card plans at banks. Many diversified creditors such as commercial banks tightened their lending standards and deemphasized their credit card business in favor of other types of lending that seemed more profitable at the time. Some institutions stopped accepting new credit card accounts.

Now that credit card programs generally have become profitable again, many credit card issuers have intensified their efforts to market new credit card accounts and to encourage account usage. That is, credit card issuers in most cases have responded to falling costs of funding their operations mainly by increasing the availability of credit card accounts rather than by reducing finance rates. This move has helped to reverse the earlier curtailment of credit card lending that card issuers undertook when market

evidence suggests that revenues have stayed well in line with total costs notwithstanding the minimal variation in finance rates. Furthermore, in recent months there has been some tendency for credit card rates to decline. Efforts to constrain credit card rates through federal regulation are likely to have undesirable side effects in the form of reduced credit availability, especially for those consumers that these bills would seek to aid. Moreover, they may encourage less efficient means of offsetting costs of credit card operations. Accordingly, the Board concludes that it would be inappropriate to impose a federal ceiling on credit card rates.

Senator GORTON. Thank you, Governor Rice.

We will have a number of questions for you. I'd like to start by stating that on page 6 of your written statement this appears: "It may be that a growing number of credit card issuers are now in a position to consider offering somewhat lower finance rates."

POSSIBLE DOWNWARD MOVEMENT IN RATES

I'd like to press you on that. Do you expect to see a downward movement in credit card rates soon and is that an appropriate response to market conditions?

Mr. RICE. Well, I can't predict the future course of interest rates. All I can do is look at what has happened in recent months and that is that we have seen some tendency for rates to decline. This has already been pointed to.

We have also seen a number of banks come out with substantially lower initial rates, like 12.5 percent as was pointed out. Here in Washington we've seen advertisements for 14 percent locally. Whether this presages a general decline in credit card rates, I am unable to say.

Senator GORTON. But in your view, does it reflect market conditions and competition?

Mr. RICE. I think it does.

Senator GORTON. You also state in your testimony that the net return to credit card issuers doesn't seem out of line with that in other lines of business. Yet, as you know, we now see the Independent Bankers making a major push to get their members into the credit card business and the attractiveness of credit card operations has been cited in a number of fields as one of the reasons for the attractiveness of the nonbank bank loophole.

If these operations are not especially profitable or more than normally profitable, why are we seeing such a rush to enter the market?

Mr. RICE. Well, the net earnings before taxes on average, according to our functional cost analysis, in 1984 were about 3 percent. That was the average. Obviously, a number of banks were earning more than that and some were earning less, and some were actually losing money, of course.

What I would suggest is that the credit card business has moved in recent years from a business that really wasn't profitable—where most banks and institutions were losing money—into a business that has become profitable. This 3-percent rate of return that I mentioned is relatively high compared with the experience of the last dozen years. As the business becomes more profitable, a larger number of institutions feel that they can make a go of it.

Senator GORTON. Do you know what the relative share of the income of card issuers come from service charges and fees as against interest income?

Mr. RICE. Yes, I just happen to have that for 1984. I'm sorry, did you say income or expenses?

Senator GORTON. What's your——

Mr. RICE. In 1984 total income, including fees and merchant discount, averaged 25 percent of the total amount of credit outstanding. For comparison, the cost of funds constituted 8.3 percent; fraud and losses, 1.2 percent; and operating costs, 12.3 percent.

Senator GORTON. That's very interesting and I'm happy to have it, but that wasn't my question.

Of the income to the card issuer, what share comes from services charges and fees and from the merchant discount as opposed to interest income from the cardholder?

Mr. RICE. Could I allow my assistant to respond?

Senator GORTON. Of course. Would he identify himself and give us the answer?

Mr. FERGUS. My name is James Fergus. I'm an economist at the Federal Reserve Board. Your question concerns which component of income, Senator?

Senator GORTON. Well, of the income of the card issuer, how much comes from services charges and other fees charged to the cardholder, how much from the merchant discount, and how much is interest income?

Mr. FERGUS. Senator, the available data on that are limited and imprecise. However, from the functional cost analysis information that we have available, it appears that 60 percent approximately constitutes finance charge revenues. It appears that about a quarter reflects the merchant discount. That comes to a total of 85 percent. So the remainder would constitute interchange fees among institutions as well as annual fees and other types of charges.

Senator GORTON. Thank you. Either Governor Rice or you, when we look at these interest rates, by how much is that reduced by reason of the ability in most cases of a credit cardholder to pay without any charge at all by the end of the month? The number of credit cardholders who don't pay any interest at all because they pay their bills promptly at the end of the month, how much would that reduce the effective interest rate overall?

Mr. FERGUS. The effective interest rate earned, Senator, as revenue?

Senator GORTON. Well, the effective interest rate paid by all credit cardholders taken as a group?

HALF OF CARDHOLDERS PAY OFF EACH PERIOD

Mr. FERGUS. That is again rather difficult to say with any great degree of precision, Senator. However, it appears that about 50 percent, as I believe Governor Rice mentioned in his statement, do pay off during the interest rate period. So there's a considerable reduction in the effective rate earned.

Senator GORTON. It doesn't cut it in half.

Mr. FERGUS. I wouldn't say cut in half, Senator, no.

Senator GORTON. Well, can you give me any estimate at all?

Mr. RICE. Senator, we might be able to furnish that.

Senator GORTON. We would like you to supply that information for us if you can.

[The following information was subsequently supplied for the record:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

EMMETT J. RICE
MEMBER OF THE BOARD

February 7, 1986

The Honorable Slade Gorton
Chairman
Subcommittee on Financial Institutions
and Consumer Affairs
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Gorton:

I am pleased to provide the additional information you requested during my testimony on credit card interest rate ceilings before the Subcommittee on Financial Institutions and Consumer Affairs on January 28. At that time, you inquired about the effective rate of interest paid by consumers on credit card borrowing, taking into account the fact that a sizable proportion of credit card users pay off their balances in full during the grace period, and therefore incur no finance charges.

Data that help answer your question are available in the annual Federal Reserve functional cost analysis, which I mentioned in my testimony. Information is given for average finance charges and for the average amount of credit card balances outstanding at banks that participated in the functional cost study. During the eleven-year period from 1974 through 1984, total finance charges paid by card holders amounted, on average, to an effective rate of about 14 percent of credit card balances outstanding. In recent years, there appears to have been some increase in the effective finance rate, from somewhat below 14 percent in 1979 to slightly more than 15 percent in 1984, the most recent year for which data are available.

These effective rates include finance charges paid on cash advances--which immediately start to earn interest for the lender as of the transaction date--as well as interest paid on credit card accounts when the total balance owed on the statement date has not been paid before the end of the interest-free grace period. If finance rates paid on cash advances and the amount of cash advances outstanding are excluded, the effective interest rate on the remaining credit card balances in 1984 averaged about 15 percent.

I hope this information will be helpful to you.

Sincerely,

Emmett J. Rice

Senator GORTON. Governor Rice, at the time of which your opening statement was interrupted by Senator D'Amato, you were speaking about the study which the Federal Reserve is conducting on the benefits of providing consumers with comparative cost information about closed-end credit, and you suggest that we wait until those results are available.

When are they going to be available to us?

Mr. RICE. The study should be finished by the end of June, that is the first draft, and it should be ready for publication I'd say in early fall.

Senator GORTON. Just about the time this Congress adjourns sine die.

Mr. RICE. We've been working on it for some time.

Senator GORTON. Thank you. You note in your testimony that credit card issuers have appeared to have responded to falling costs not by reducing interest charges but by easing the availability of their credit. You implied that in many respects that's a good thing because that availability was in the process of being restricted at the end of the 1970's and the early 1980's.

On the other hand, there are a number of studies and a number of people who state that the overwhelming easy availability of cards approaches being a scandal with unsolicited preapproved credit applications appearing in mailboxes all over the country and, of course, it's the losses from that kind of credit that keep rates unnecessarily high for all kinds of other and very good credit cardholders.

Do you think that there are a number of banks which have been too cavalier in extending credit cards? Has that led to an unwarranted increase in cost and has it not had an impact, which I believe has been publicly criticized by the Chairman of the Federal Reserve Board, and has it not contributed materially to an unwise accumulation of consumer debt?

Mr. RICE. Mr. Chairman, there may have been some excesses in credit card issuance. I don't know. I'm just not in a position to make a judgment on that, but if there have been, it seems to me that this legislation is not the best way to deal with that problem.

FEDERAL INTERVENTION COULD HURT LOW-INCOME USERS

What this does is to restrict availability to people who might not have other alternative sources for credit. If issuers are induced to tighten standards, this would perhaps cut out some low-income users of credit cards. Even under current conditions it's wealthy, high-income people who are by far the major users of credit cards. Over 90 percent of the people with incomes over $50,000 have credit cards, but this percentage drops off substantially as income declines.

Now if you take action which causes card issuers to tighten standards, you certainly run a very high risk of cutting out the few lower income credit card users and forcing them to use less convenient credit substitutes.

Senator GORTON. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Senator GORTON. The two Senators I'm sure would be happy to answer questions as well.

Senator PROXMIRE. I'm sure they would, too.

May I first ask my good friend, Al D'Amato, the Senator from New York, Senator D'Amato you say on the last page of your statement:

> I believe that consumer awareness and the threat of legislation imposing a national ceiling would compel issuers to lower their rates is preferable to the imposition of a credit card ceiling.

Senator D'AMATO. Absolutely.

Senator PROXMIRE. Then you go on to say:

> However, if the credit card industry is not a free market, then Congress should take appropriate steps to ensure that interest rates are fair.

Now what you're saying, as I take it then, is that you don't want to see a bill enacted if possible.

Senator D'AMATO. Correct. I would rather see a real free competitive system, Senator Proxmire, and I think one of the ways to do it is to get the information available. For example, I don't believe———

Senator PROXMIRE. Al, let me ask the question.

Senator D'AMATO. All right.

Senator PROXMIRE. The question is this. How much time do you think that the banks and other credit card issuers should have to act before you feel we should act on your bill?

Senator D'AMATO. I think 3 months would be more than enough. We've had this bill introduced at the beginning of the session or as we went out of session last year. We've talked about it. Senator Hawkins has had her bill in for a number of months. I've held a number of hearings up in New York about it.

I would also hope—one of the things I didn't know, for example, I didn't know that if you got a credit card from an out-of-town bank that it would be one that would be readily acceptable in the merchants in your area. I wonder how many people—I confess my ignorance on that. So I think, Bill, if we get the consumers the information, then we can make the competitive forces work. But at the present time, if you look at what they did in New York, the four large money center banks all had their rates of interest pegged within three-tenths of 1 percent and there was no opportunity for the consumer to shop around, nor did they know that that Mastercard or VISA card could be obtained by a small bank out of town and it would give them the same ability to any shopkeeper in their own town.

Senator PROXMIRE. Senator, you've told me 3 months. How much would interest rates have to decline before you felt they were taking proper action?

Senator D'AMATO. I think, Senator, that when we look at Manufacturers Hanover that came down 2 percent immediately that at the very least we could see a 2-percent drop. I would bet that then you would begin to see the forces of competition set in and they would come down more and that the fact is, the banks charging 14 percent would be making a 40 percent—that's not 4 percent—a 40-percent profit on that money, not including the service fees that they charge and not including the discount of 4 percent that they

get from the usual shopkeepers for each purchase, which again is about 40 percent.

Senator PROXMIRE. Let me ask you this. The banks have argued that lower interest rate ceilings will cause them to limit the number of credit cards they put into the hands of marginal credit risks.

Senator D'AMATO. Wouldn't that be wonderful?

Senator PROXMIRE. Well, I'm not sure. I want to finish my question. Let me do it. They say this means that it would be a lot harder for low- or moderate-income persons to get a credit card compared to today.

In responding to that argument, here's what you say on page 10 of your statement:

> If certain individuals pose too great a risk to the credit card issuers, then credit should not be extended to them. It seems unfair to charge everyone the same high rates due to the fear that a small percentage will fail to pay off their balances.

I find that answer somewhat disturbing because in effect you're saying that we sitting here in Washington should make a judgment about who is creditworthy and who is not. If our interest rate ceiling force some individuals out of the credit market, well, we'll just tell them to get lost.

Senator D'AMATO. No.

Senator PROXMIRE. Are we really smart enough to know who's a good credit risk and who isn't and shouldn't we let the market make those decisions?

Senator D'AMATO. Perhaps not, but if we impose a floating ceiling, banks may be forced to make this determination. The fact of the matter is that there's been a total abdication of this role that should be played by the banks. In order to obtain market share card issuers give it to everybody, give it to pets, to dogs. We've got an article here from the Wall Street Journal where they sent it to prisoners, people in prison. Teenagers, my own son got one, 17 years old. They mail them to everybody. You take it. We just want to get it out there. As a matter of fact, this is a Bill Proxmire speech I'm making. My gosh, shouldn't there be some responsibility in terms of giving out these credit cards to see that there's some ability to repay or do we want to entrap everybody and get them into that credit card charge and then hit them with 22 and 23 percent on the unpaid balance when we know they're not going to pay it. By the way, they don't want them to pay it. There's over $110 billion out there in credit card charges today on unpaid balances and they're getting smacked at better than 20 percent.

Senator PROXMIRE. Senator D'Amato, you know perfectly well we're not talking about dogs and and we're not talking about cats.

Senator D'AMATO. Well, they're mailed to dogs, to cats, to teenagers, to prisoners so my response is relevant and sorry to say accurate.

Senator PROXMIRE. All right. Let me——

Senator D'AMATO. Let me fully answer your question.

Senator PROXMIRE. That will be 10 minutes. I have some questions for some other witnesses.

Senator D'AMATO. Well, I wanted to respond completely. I do think that the banks have a responsibility to see to it that there is

rates moved up and many lenders were unable to adjust their income to match the rising costs of funding and operations. Thus, it appears that much of the inertia in credit card interest rates has been attributable to the influence of restrictive rate ceilings imposed by the states.

Of course, rate ceilings in the credit card market are considerably less pervasive now than they were before 1980, because a number of states have raised or removed applicable rate ceilings, or have permitted lenders to charge annual fees for credit card accounts. These changes, besides the declines in the cost of funds, contributed to the rise in the overall net return, before taxes, on credit card plans at respondent banks to about 3-1/2 percent in 1984. So it may be that a growing number of credit card issuers now are in a position to consider offering somewhat lower finance rates to credit card borrowers as some institutions already have done.

Factors on the demand side of the market also may have been conducive to the observed stability of interest rates on credit card plans. As noted earlier, a substantial share of card holders either use their credit cards infrequently or usually pay off their credit card balances promptly. These card holders are thus likely to base their choice of credit card plans on features other than the level of finance charges.

Also, even for card holders who "roll over" their balances and pay finance charges, other characteristics of credit card borrowing, such as convenience and suitability for small transactions, may outweigh any rate disadvantage. Whatever the case, credit card debt has expanded rapidly for more than two years--a sign that consumers view credit card use as an attractive source of short-term financing despite what many observers regard as high rates of interest.

Furthermore, the recent emergence of above-average returns to bank credit card lending may not lead to an immediate, widespread reduction in finance rates on credit card borrowing. Credit card issuers may be uncertain whether such favorable conditions will persist. Also, instead of offering lower finance rates, card issuers may seek to compete by easing credit standards somewhat, by making nonrate credit terms more attractive, or by offering other products and services.

In this connection, one should keep in mind that finance rates on credit cards already have shown some tendency to decline. The average finance rate on bank credit card plans at reporting banks moved down by 25 basis points, on balance, during 1985; at year end, it was the lowest in more than three years. In the course of readjusting their finance rates, some credit card issuers have adopted floating finance rates of the general kind proposed by the legislation under review. However, those adjustable rates often have been paired with the imposition of annual credit card fees.

An effort to establish a federally mandated ceiling on credit card interest rates would likely encounter substantial difficulties. From experience with the imposition of credit controls in 1980 and the sharp, unexpected contraction in consumer spending that accompanied them, we know that regulatory measures can have unpredictable and unwanted consequences. Setting a federal ceiling on credit card rates below those that currently prevail in many states would likely reduce the amount of credit made available, forcing consumers to rely instead on less convenient and possibly more expensive substitutes, or to lose access to credit at any rate. Moreover, such a curtailment would be apt to fall most heavily on less affluent borrowers with relatively limited access to other sources of credit. The current

ceiling for credit card rates under the proposed bills would be in the vicinity of 13 to 14 percent, well below the finance rates that have been typical since credit cards emerged in the early 1960s as a major method of consumer financing.

Furthermore, the imposition of stringent rate ceilings might be countered by a tightening of nonrate credit card terms by card issuers, for example, by increasing annual fees, by levying processing charges on each credit card purchase or cash advance, and by stiffening penalties for late payments or for exceeding the authorized credit limit. Some card issuers also might begin applying the reduced finance charges from the date of purchase, where permitted, rather than after the grace period expires, and might seek to increase the discount fees charged to merchants who submit credit card vouchers to them for payment.

Turning to the specific provisions of the two bills before the Congress, it should be emphasized that credit cards are issued by a broad variety of retail merchants and financial institutions that differ both as to their sources of funding and their liability structures. Under these circumstances, a single index rate would be unlikely to mirror changes in costs for such a diverse array of card issuers. In any case, short-term rates, such as on Treasury bills, fluctuate a good deal more widely than costs of funds of most lenders. They do so because a lender's overall average cost of funds at any point is a blend of current interest rates and rates on previously issued liabilities, and because market rates on longer-term liabilities--which usually make up part of the cost of funds--typically vary less than shorter-term rates.

Another question at issue is whether any regulation of credit card interest rates is more appropriately a matter for federal or for state intervention. In contrast to efforts at the federal level to assure the safety and soundness of financial institutions, the establishment of interest rate ceilings on consumer loans has long been a state prerogative, and one that the Board feels should not be preempted. In recent years, virtually every state has reviewed and overhauled its laws regulating consumer interest rates. After studying the situation in their own jurisdictions, many of the states have opted to raise or remove interest rate ceilings for credit card borrowings. The Board respects the collective judgment of a growing number of states that higher--not lower--ceilings are appropriate to assure that an adequate supply of credit card services is available from lenders located there. Of course, these states retain the authority to lower or restore ceilings if convincing evidence of excessive rates appeared.

In addition to the issue of the desirability of federal rate regulations that is central to both proposals under review, there are certain other aspects of S.1922 about which the Board would like to comment. Section 3 would amend the Truth in Lending Act to require that credit card issuers clearly and conspicuously disclose on initial applications for credit cards the annual percentage rate to be charged for credit extensions made with the credit card--or the means of determining that rate--and any annual or other fee imposed for issuing or using the credit card.

Many of us routinely receive credit card solicitations in the mail inviting us to apply for a particular credit card program. Generally, credit card mail solicitations are considered advertisements under the Truth in Lending Act. If a credit card issuer includes in an advertisement any of the specific

credit cost terms of its credit card program, then current disclosure rules under Truth in Lending and the Federal Reserve Board's Regulation Z require the card issuer to clearly disclose at that time additional important credit cost information--for example, minimum finance charges, transaction charges, membership or participation fees, and any annual percentage rate that may be applied. However, if no cost information is contained in the mail solicitation, the card issuer is not now required to include the Truth in Lending disclosures. In such cases, the proposed disclosure requirements probably would aid consumers in comparing offers to apply for particular credit card programs.

S.1922 also would require each credit card issuer to report to the Board on a monthly basis the average annual percentage rate and any annual or other fee applicable during the preceding month. While this idea may seem appealing on initial examination, there are a number of questions about its practicality and cost that would need to be considered. In that connection, the Federal Reserve currently is analyzing the results of a study that is being conducted at the request of the Congress to measure the benefits of providing consumers with comparative cost information about closed-end credit. The findings from this project will provide a means of better evaluating the use that consumers make of published lists of comparative rate data in the process of obtaining credit. In view of the costs that would be associated with the collection and dissemination of comprehensive information about credit card interest rates and fees, the Board suggests that the Congress consider postponing any action in this area until the results of the demonstration project are available.

Section 4 of S.1922 would direct the Consumer Advisory Council of the Federal Reserve Board to transmit a report to the Congress each year

describing and analyzing several detailed aspects of credit card markets. Among the matters to be addressed would be the costs and risks of issuing credit cards, the proportion of credit card customers whose cards have been revoked for nonpayment or delinquent payments, revenues received by credit card issuers derived from finance charges, annual fees, and application fees, and the impact of the statutory rate ceiling on consumers and card issuers. The preparation of such a comprehensive document, however, would far exceed the range of the Council's own resources.

As you may know, the Consumer Advisory Council is an independent advisory group to the Board. It consists of 30 individuals drawn from the financial services industry, the academic community, state government offices, consumer advocacy groups, legal aid offices, and community organizations. Its function is to provide the Board with a cross-section of informed opinion about current regulatory matters in the area of consumer financial affairs. Members of the Council meet three times a year for one-and-a-half day sessions to consult with the Board on various questions related to the Board's consumer financial protection responsibilities. As an outside advisory body, the Council has no independent staff; as needed, it draws on Board staff support. Therefore, the duties assigned to the Council under Section 4 of S. 1922, requiring a substantial information gathering and analysis effort, would go well beyond the Council's capabilities and perhaps would even be inconsistent with its consultative nature.

In closing, I would like to reemphasize the Board's conviction that financial markets distribute credit most efficiently and productively when interest rates are determined in markets that are as free from artificial restraints as possible. In the credit card business, the balance of the

an ability, there is some creditworthiness, before they give out this document.

Senator PROXMIRE. I do too, but I think this is something the banks can decide.

Senator D'AMATO. Your right, they can decide but the sad fact is they haven't done it. It appears such determinations would impede their ability to charge high rates. What they've said is, "We're going to rip off everybody because this way we don't even have to look into whether or not you're creditworthy," and they're doing a heck of a job.

Senator PROXMIRE. Senator Hawkins, let me ask you a question if I might.

Senator HAWKINS. All right. I really have missed this committee.

WAYS TO CIRCUMVENT A RATE CEILING

Senator PROXMIRE. There are many ways a bank can get around a Federal interest rate ceiling. It can increase annual membership fees; it can impose transaction fees; it can change its billing system to increase its effective yield; it can increase the fee it charges merchants thus burying the cost in the price of merchandise; it can reduce or eliminate the free ride period.

It seems to me if the objective is to reduce the cost of credit cards to the consumer, you would have to legislate in each of these areas to prevent the ceiling from being circumvented.

Would you support the regulation of all of these escape hatches if we move forward on the rate ceiling legislation? And if we do so, aren't we just in a miasma of regulations that are self-defeating?

Senator HAWKINS. No; my bill is so simple. It seems to me that we're all talking about oligopoly. I hear how close all interest rates are in banks. I see flashy incentives competition rather than pure costs. If we peg it 5 percent above the T-bill banks will have flexibility to operate.

Senator PROXMIRE. I understand. My point, though, is if we put a cap on it, say make it 14 or 13 percent——

Senator HAWKINS. It would be 5 percentage points above a 6-month T-bill.

Senator PROXMIRE. You want to relate it to the prime rate or one of the free market rates, but whichever it is, it will simply force them into these other areas where they can make charges and you won't have any overall effect.

Senator HAWKINS. I disagree. I do not believe that banks need to charge outrageous rates to cover costs.

Senator PROXMIRE. Let me ask you this. I understand you to say that consumers are being overcharged by $9 billion a year.

Senator HAWKINS. Yes.

Senator PROXMIRE. Can you provide for the record how you arrived at that figure?

Senator HAWKINS. Sure will. $6 billion in interest, and $3 billion in payment for annual fees.

[Response to Senator Proxmire from Senator Hawkins follows:]

In response to Mr. Proxmire's question as to where Mrs. Hawkins came up with $9 billion on consumer credit cards interest.

The figure was obtained from the Consumer Federation of America which makes its claim on the basis of Federal Reserve data, that consumers are paying between

$6 and $8.6 billion a year in interest on bank credit cards, plus an estimated $3 billion from dues on annual fees. We used an average of both figures to come up with $9 billion.

Senator PROXMIRE. Governor Rice, you say in your statement that the rate of return on credit cards for issuing institutions is less than another loan. I understood you to say that.

Mr. RICE. Yes; that's true if you look back over the last 12 years.

Senator PROXMIRE. Well, I would take it that it would go up and down, but on the average over the last 12 years it's been less. Does that mean that if a limit is put on interest rates charged by credit card issuers they would shift to one of these other areas, a shorter grace period or a bigger charge to the merchants or whatever?

Mr. RICE. I would certainly think so because by placing such ceilings, as proposed, you would reduce profitability and credit issuers would have to look at other terms.

Senator PROXMIRE. Now consumer organizations that testify later recognize that this might happen and what they propose is that we limit all these other areas. What do you think of that kind of action?

Mr. RICE. Well, I think then you've become involved in a morass of regulatory redtape. It would be a regulatory nightmare.

Senator PROXMIRE. Now contrary to what some are saying, consumers are not getting all the information they need to compare and shop around for credit cards at the best rate to fit their needs and pocketbooks. Isn't that a good indication of the need for the Federal Reserve to publish a consumer shopping guide to credit?

Mr. RICE. As I said in my statement, we don't know yet. We are studying that now.

Senator PROXMIRE. Why shouldn't that be obvious? I'm talking about disclosure. I'm not talking about more regulation. I'm talking about simply giving consumers more information.

Mr. RICE. Certainly, there's nothing wrong with disclosure and I am not arguing against disclosure. The question is: Is the disclosure beneficial? And this is what we're trying to find out in the study. The study involves the publication of shopping guides and then evaluating, on the basis of interviews and surveys, whether this information has proved of value to consumers.

Senator PROXMIRE. I have one more question if I might.

Mr. RICE. I just want to say that no one is opposed to disclosures. It's just a question of whether they're beneficial. If they are, fine.

Senator PROXMIRE. My last question is this, Governor Rice. In early 1980, the Carter administration used the Credit Control Act to control credit card credit. What was the economic effect of these controls? Did they help stop inflation or not?

CONTROLS DISCOURAGED CONSUMER SPENDING

Mr. RICE. No, they did not help stop inflation. As you know, inflation continued to gather momentum after 1980. What it did was to discourage consumer spending. Consumer spending fell off very sharply. Consumer credit extensions came close to a halt. And as you know, there were fairly severe economic consequences of this action.

Senator PROXMIRE. So you're saying that if you're going to tamper with the credit system you should be very careful about the economic consequences?

Mr. RICE. You should be very careful because the effects are unpredictable.

Senator PROXMIRE. Thank you, sir.

Thank you, Mr. Chairman. My time is up.

Senator GORTON. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. I did not make an opening statement but after listening to all the discourse here I think perhaps something should be said.

Having been a businessman before I became a Senator for over 35 years and a small banker for 25 years, I'd like to point out a couple of very, very important facts.

There has never in the history of America been anything so consumer oriented as the credit card. Now let's just look at what this can do. This can allow any American to go and shop anywhere they want. They can open that morning's paper and see a sale of 50 percent off and run to that store and they can take a trip, shop in Europe. They can shop in Asia. They can go wherever they want to go.

After all, before these credit cards came out this consumer could not do anything like that. They had to go to one particular store or pay cash someplace else.

As a small businessman I'm going to throw a figure out at you and I think it's very, very low. I would estimate that if you would take the credit cards away from the small businessman of America today 75 percent of them could not make it. I would probably feel it's closer to 90 percent. Because, first of all, Senator D'Amato, I want to point out one thing to you. I had several businesses. In one I paid 2.75 percent for a credit card to the bank, and two others I paid 3 percent. So the 4 percent is not a firm figure and it's according to what your average unit sale is and your cost of taking care of this particular customer.

Senator D'AMATO. When was that, Senator?

Senator HECHT. Right before I came to the U.S. Senate, 3 years ago, when I used to work 7 days a week for a living.

Senator D'AMATO. They've raised it.

Senator HECHT. Besides the small businessman I was trying to think who else profits by this? I use it to go to my dentist, my doctor, repairman, airline tickets, theater tickets, restaurants, liquor stores, grocery stores. They've become a part of America.

Now we're talking about this exorbitant charge. First of all, if you pay it in 30 days there is no charge. How much convenience can you give to the American consumer? Now if a person, for instance—take a couple of my children. They have a charge of $65 at the end of the month. They cannot go to a bank and get a loan for $65. The bank is not set up for it. If they went to a small loan company there would be a much higher charge than what they're paying.

I'm not sure these figures are right, but what I do want to point out is when you start tampering with something that is so fundamental to America and has enabled the American consumer to purchase much better than they've ever had before, has enabled

the small businessman of America to stay in business, and if you will notice the statistics the past few years it is the small businessperson in America which has expanded. They are the ones that are doing the hiring. It is not the large businesses because they are compressing themselves and merging.

So I would just ask you one question, Senator. Have you taken all of this into consideration before you introduced your bill?

Senator D'AMATO. My good friend, Senator Hecht, not only have I taken it into consideration, but it's exactly for those reasons that I have introduced this legislation, because we are not only addicted to credit cards but it has become an absolute necessity. Senator Hawkins said it well. Try to cash a check. You can't do it. Try to put up cash, merchants don't have that much on hand and it takes forever to get change.

Our whole economy is geared to the credit card. And the banks have taken advantage of this by coming together and charging unreasonably high interest rates that are not justified by their cost of borrowing or their cost of operation.

Second, I'm not looking to ban credit cards. I want them to be used. As a matter of fact, we fought out a battle that said that people shouldn't be charged additional amounts—a 5-percent surcharge I believe—because they are using a credit card. I said absolutely, no way, because this has become a way of life.

NEED FOR COST OF CREDIT CARDS INFORMATION

I think it's important to say at least let's give consumers—and part of the legislation that I'd like to ask the Governor a question about—shouldn't the Federal Reserve give out this information to consumers as to what the cost of credit cards are throughout the country? Why shouldn't they do that at the very least? And then to say that you would have a floating ceiling, not an absolute ceiling, but one that was pegged to the cost of money. Why shouldn't we have that? And if a bank can't make a profit when it's getting 40 percent over and above what the cost of money is, then we're in deep trouble and they're making loans to people that they shouldn't be making loans to, and the rest of the people shouldn't be paying for that.

Senator HECHT. Senator, I think there's 14,500 commercial banks in America today roughly. I think you will find, with the exception of the larger banks, most banks are marginal on making money on these credit cards. It's certainly not a big money-making part of the average small bank in America today.

But that small bank could not give a credit card if it were not for the major banks that are taking the appropriate risks on that credit card, and sometimes, by legislation like this, trying to help the consumer what you are doing is hurting the consumer, not helping him, because if we start to regulate interest rates and the banks say, "Listen, it's marginal right now. Let's just drop it." Then what happens to the American consumer?

Senator D'AMATO. Well, let me ask you this. Don't you think that the American consumer should know that there are banks that are charging rates that are 7 and 8 percent less and wouldn't

that information then give him the ability to shop? You wouldn't be opposed to that, would you?

Senator HECHT. There's 14,500 commercial banks as I just said. Do you think that we as a Government function should publicize the rates that every one of these banks charge every week?

Senator D'AMATO. Every month, absolutely. These people at the Federal Reserve collect information of every shape and form from those banks and I don't believe that it would cost them anything for once a month to make that information available. Many of them don't have credit charges, but why shouldn't they make it available for the consumer so that the consumer could shop around. Faced with this type of educated consumer you'd see those large money center banks drop their rates if they began to see people going to Union National Bank down in Arkansas because they could get rates at 12.5 percent. You would see those 19.7 percent rates come down. It doesn't cost anything. The marketplace will work, only if the people have the information and the ability to make it work. They don't now.

Senator GORTON. Senator D'Amato, you had a question you wanted to ask Governor Rice?

Senator D'AMATO. Governor, do you really believe it would be an undue burden to collect from those banks that do issue credit cards once a month to have them report their rates? By the way, they report to you more than once a month now, don't they, regularly on all kinds of matters?

Mr. RICE. Some do, but not all banks.

Senator D'AMATO. Well, to have them report to you what the interest rate charges that they are charging on their credit cards, do you think that would be a burden?

SUBSTANTIAL BURDEN ON THE BANKS

Mr. RICE. It would certainly be a burden. Whether it would be an undue burden or not is a judgment to be made, but it would be a very substantial burden.

Senator D'AMATO. A substantial burden?

Mr. RICE. Yes; every time you have to make a financial report it's a burden.

Senator D'AMATO. It's a financial report that constitutes indicating to the Federal Reserve what the monthly charge is on their credit cards. That's all.

Mr. RICE. Any kind of report to the Federal Reserve takes time and is a burden and involves some costs.

Senator D'AMATO. And you don't think that the cost-benefit ratio between that information then being made available to the consumers is not worth it?

Mr. RICE. I did not say that.

Senator D'AMATO. But you implied it.

Mr. RICE. May I answer the question?

Senator D'AMATO. Sure.

Mr. RICE. I did not say, and I emphasize, I did not say it would be an undue burden. That's a judgmental thing. I said it would be a burden.

Senator D'AMATO. Well, I'm asking you.

Mr. RICE. I would like to remind you, Senator, you have a Paperwork Reduction Act on the books which we have to comply with.

Senator D'AMATO. I'm asking you, in your opinion, whether or not it would be reasonable to ask the banks to report what the interest rates are once a month on credit card charges so that you, the Federal Reserve, would then make that information available periodically? Do you think that's an undue burden, given the relationship to what we're attempting to seek, to give the consumers the ability to comparison shop?

Mr. RICE. It depends on the benefits that consumers would derive from this information and that's one of the things that we're trying to find out. You are presuming that the consumers will benefit substantially.

Senator D'AMATO. Well, if consumers knew that there were institutions where they could save 70 percent of the interest costs that they are now paying—not 7 percent— it's 70 percent of the interest costs that they're now paying, don't you think that many of them would take advantage of that? What about those low-income people? What about those working, poor people who at the Christmas season and the holiday seasons go out there and have these large balances? Don't you think they should have that knowledge that they could go out and save 70 percent in terms of the interest costs that they will be forced to pay on those balances? You know, there's $110 billion worth of consumer credit out there that is being whacked with these charges and $330-plus billion that was charged last year and $110 billion in unpaid balances, and if you have a balance of 20 percent per annum, don't you think you should give a lot of those people the opportunity to say, "My gosh, I could save a lot of money."

Mr. RICE. I'm certainly not opposed to making information available.

Senator D'AMATO. Thank you.

Senator GORTON. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman. I gather I missed some fireworks.

Senator D'AMATO. No, a brush fire.

Senator DODD. First of all, Mr. Chairman, I would ask unanimous consent that my opening statement be put in the record.

Senator GORTON. It will at the appropriate place.

Senator DODD. I thank you for that.

Governor, let me if I can address a couple of questions to you. Maybe I should ask my colleague from New York whether or not he would be in agreement with this. He may have indicated this before I came in, but it seems to me part of the problem is trying to determine whether or not we ought to recognize a State's rights to set its own usury laws. The problem here obviously is one where forum shopping can go on. Institutions can go to those States that either have no ceilings or have very high ceilings. I wonder if my colleague from New York might be willing to support an effort, if one were undertaken, to have Congress establish as the rate on credit card interest as the rate established in the consumer's State of residence rather than in the State of issuance of the credit card itself, and let that be the barometer. Rather than trying to set a Federal standard, just switch the ground a little bit and have the

consumer's State be the State of determining what the rate ought to be.

INABILITY OF THE STATES TO DEAL WITH THE PROBLEM

Senator D'AMATO. My colleague from Connecticut accurately describes the inability of States to deal with the problem, as we've held hearings in the State of New York and we have unanimously decided that the State could do little, if anything. It is the State of issuance which ultimately affects the interest rate charge so an issuer could relocate in a more advantageous locale. I'm not so sure that that's the answer. I'm not so sure that we could really impose these ceilings due to the banks opposition, but I am very certain, though, that we should move to get that kind of information to consumers that would make available competition that people talk about but that is absolutely totally lacking. Those people don't have that information and, consequently, there is no real price competition.

Senator DODD. In addition to the rate itself, there are a number of other issues which are important. The rate itself is the thing that is maybe the most understandable to people if they know what that monthly charge would be. Going down a long list, for instance, the Union National Bank of Little Rock, AR, has an interest rate of 12.5 percent, which is one of the lowest rates, at least as I look down a list of States and various parts of the country. So, 12.5 may be the lowest, one of the lowest at any rate—I guess there's a lower one at Vienna, VA. But they have, for instance, no grace period whatsoever. So that that 12.5-percent charge, while it's a very attractive rate and would, I presume, appear very appealing to a consumer when shopping for a bank with which it would like to do business in terms of its credit card, and looks at a bank that, say, charges in Dallas, TX, Interfirst Bank of Dallas—well, that doesn't have a grace period—let's find one here that does—the Simmons First National Bank in Pine Bluff, AR, they've got a 25-day grace period.

There, while the rate may be a bit higher, actually the grace period is one that would probably mean that that consumer was actually paying less. Yet if all the attention is focused on the rate itself without looking at the other features that that particular institution provides, then it seems to me we may be misleading the consumers into believing that somehow because we're going to require or post different rates that they're actually getting a better deal.

So the question becomes not only should we be looking at the rate question, but also all of the other aspects.

Senator D'AMATO. Absolutely.

Senator DODD. Now I don't know, Governor, if you would like to comment on that particular aspect of this or not. But are we only looking at a piece of the action here and not looking at the other elements in determining what is actually a better deal, if you will, for the consumer?

Mr. RICE. Well, that's absolutely correct, Senator. The rate charged is simply one of several types of terms or one element in pricing. You pointed to some of them—the annual fee, the grace

period, all of those—whether there are other additional services that go along with it like travel insurance, et cetera. There are a number of enhancements that can be added or taken away.

So the interest rate is simply one element in the pricing of the product.

Senator DODD. Well, might not it—and I would be curious as to your opinion of this—what would you recommend with regard to a suggestion to amend truth-in-lending legislation to require a full disclosure, not just of rates but of all these various elements so that consumers might have the full picture in terms of what is available to them?

Mr. RICE. They do; the Truth-in-Lending Act does provide for disclosure before they get the credit card.

Senator DODD. Not the full kind of disclosure we talk about in terms of grace period and annual fee.

Mr. RICE. Grace period and annual fee——

Senator DODD. Not in the solicitation. Once you've got the card, it's required, but if you're going to solicit, as we do all get this stuff in the mail——

Mr. RICE. That's true. At the solicitation stage, of course, they may or may not provide truth-in-lending information.

INFORMATION AVAILABLE DURING SOLICITATION PERIOD

Senator DODD. That's the most important period in my own mind in terms of making the decision as a consumer as to which company you wish to choose, it seems to me that during that solicitation period you ought to have the most information available.

Mr. RICE. It would probably be nice to have more information if you're a consumer.

Senator DODD. Well, aside from being nice, should we mandate it? Would you support legislation which would require it?

Mr. RICE. I probably would support providing more of the relevant information at the point and at the time of solicitation. Personally, I probably would support that.

Senator DODD. I appreciate that. I don't know whether my colleague from New York—do you have a view on that at all?

Senator D'AMATO. We intend to provide that information upon solicitation. I agree with my distinguished colleague from Connecticut. I think that's an important step forward and I think also the reporting of what those rates and conditions are on a monthly basis would also give people information so that they will have the opportunity to examine the relevant terms before they have that card. Most Americans—7 out of 10—already have made a commitment by using the card when they find out about the real costs of the card. I think it's a matter of letting them know that there are alternative cards in many cases so they could save substantial sums.

But I commend the Senator for honing right in on that point and that makes so much sense and could provide so much protection to consumers.

Mr. RICE. I just want to emphasize they do get the information though before they start using the credit card.

Senator DODD. Yes.

Mr. RICE. And they don't have to then use it.

Senator DODD. No, but my thought was on the solicitation because there obviously with clever advertising or promotional techniques—certainly those of those on this side of the table are not foreign to whatsoever can have a great deal to do with who's successful in securing the business—but I think if we required that it might be a bit better.

Back in 1983, Manuel Johnson testified before the predecessor of this committee. He suggested that consumer loan rates were not highly competitive. I'm quoting him here. He said:

> Consumer loan rates are generally considered to be administered rates. That is, they are posted by lenders rather than set by the market under interaction supply and demand conditions.

I'm wondering, Governor, whether or not you agree with that statement and would it also be true for credit card interest rates and, if so, how would it be possible to inject some price competition into the marketplace in this particular area?

Mr. RICE. I don't think I agree with my colleague-to-be. I think there is competition in the banking business in setting credit terms and in particular in the credit card business. I don't agree with many of the statements that I've heard that this is an oligopoly structured market, that there's no competition.

First of all, I would point to the ease of entry into this market. I would point to the number of competitors in the market and I would point to the fact that there is significant dispersion in the interest rate charged by issuers around this 18-percent average.

So I would say the market is competitive. I do not agree that it's an administered market or that rates are administered.

Senator DODD. You heard me address a question to Senator D'Amato regarding a proposal some have raised, and that is to allow the resident State of the consumer to be the determining interest rate rather than the State of issuance of the credit card. We all know the South Dakota situation, to cite a specific case at hand, where there are no ceilings. There, obviously, that will allow that particular bank to set rates with no limit whatsoever.

What are your reactions, having been so candid about the proposal to deal with the Truth-in-Lending Act, what are your reactions to a proposal that would allow—rather than get into the business of the Federal Government setting those rates—and we've had an interesting debate here over the last several years on just that question itself—but rather than assume that responsibility, allow the consumer recipient of the credit card, the rate of that particular State to determine the rate. What's your reaction to that kind of suggestion?

Mr. RICE. I would say it's a matter for the States themselves to decide.

Senator DODD. But that's not the issue or the point here. The point is, under the present law, of course, the issuing State determines the rates. Why not set the rate based on where you and I live?

Mr. RICE. Would I favor Federal legislation which says it's the State of residence of the credit cardholder that would determine the applicable rate ceiling?

Senator DODD. Yes.

Mr. RICE. Well, frankly, Senator, I have not thought about this issue. It's the first time it's been posed and I would hesitate to rush into an off-the-cuff judgment about that. I'd like to think about it for a while.

Senator DODD. Well, I would appreciate it if you would give it some thought and respond back.

Mr. RICE. Let me think about it and give you a written response.

Senator DODD. I would appreciate that very, very much.

Mr. Chairman, my time has expired.

[The complete prepared statement of Senator Dodd and additional information from Mr. Rice follow:]

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Mr. Chairman, credit cards have become as common in our society as McDonald's hamburgers. There are some 700 million credit cards in the hands of some 91 million Americans. Given the importance of these cards to our daily existence, it is past time that we examined more carefully how the credit card market operates. Today's hearing focuses on some of the basic questions—whether competition is working in the credit card marketplace, or whether consumers are paying unfairly high interest rates for their credit?

The information leads us in both directions. Credit card interest rates have risen almost 2 percent during the same time that the prime rate has dropped by 50 percent. However, credit card profits are only slightly above bank profits on other loans and after many years of lagging behind them.

Credit card providers are willing to offer consumers almost anything—from lines of credit to credit insurance to setting up travel reservations—but precious few of them seem to want to offer lower interest rates.

The 9 largest credit card providers have an interest rate cluster that would make the most accurate rifleman proud, but the 10th is more than 15 percent lower and some banks offer rates that are only half the top rate.

I look forward to finding the answers to some of these apparent contradictions and I look forward to examining the different suggestions—from Federal interest rate ceilings to more disclosure of the relevant terms—for dealing with any imperfections in the marketplace.

Thank you.

BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, DC, February 25, 1986.

Hon. CHRISTOPHER J. DODD,
U.S. Senate, Washington, DC.

DEAR SENATOR DODD: During my appearance on January 28 before the Subcommittee on Financial Institutions and Consumer Affairs concerning S. 1603 and S. 1922, you asked me for my views on a proposal that a Federal statute be enacted to provide that permissible credit card finance charges would be determined by the laws of the card holder's State rather than the laws of the card issuer's state. Under the current practice, a credit card issuer usually looks to the law of the State in which it is located to determine the permissible rate that it may charge on credit card extensions of credit.

After some preliminary research and reflection on the issue, I personally remain unconvinced that the proposed action would produce the lower credit card service charges that it is intended to provide. I continue to believe that encouraging competition between credit card issuers is a preferable means of achieving lower credit card interest rates.

As you know, in 1978 the Supreme Court determined that the National Bank Act (12 U.S.C. §B 85) permits a national bank to "charge on any loan" interest at the rate allowed by the laws of the State "where the bank is located." *Marquette National Bank of Minneapolis* v. *First of Omaha Service Corp.*, 439 U.S. 299 (1978). Thus, the Supreme Court upheld the right of a national bank in Nebraska to charge its credit card customers in Minnesota a rate permissible under Nebraska law that was higher than the rate permissible under Minnesota law. In reaching its conclusion, the Supreme Court noted that the Court had discussed interstate lending transactions as early as 1839. Thus, at least since the passage of section 85's prede-

cessor statute in 1864, exportation of interest rates on interstate extensions of credit has affected the ability of States to enact and enforce intrastate usury laws. The proposal you asked me about would change this result as it deals with credit cards and would, in those instances where a card holder's State has a lower interest rate ceiling than the State where the card issuer is located, theoretically, result in lower interest rates for the consumer.

But, as a practical matter, it seems to me that the effect may be either to lessen the availability of credit cards as lenders decline to issue cards in States with low rates, or for card issuers to offset revenue losses associated with interest rate limits by eliminating grace periods, raising annual fees or imposing a transaction charge.

From the borrower's perspective, consumers in a State with laws unattractive to lenders might need to shift to noncredit card borrowings in order to find a source of funds to finance their purchases. I am also concerned that consumers in a State with a low ceiling may be denied access to the convenient form of credit provided by credit cards if they could not qualify for cards of issuers wishing to operate on the narrower profit margins created by the low ceilings. In sum, my concern is that consumer credit available in a State with low ceilings could actually be reduced by the proposal, thus providing no real benefit to consumers residing in low interest States.

I cannot say whether the issues I raised may be addressed by other means, but it does appear to me that adopting a Federal law limiting credit card rates to those permitted by the State in which the card holder resides raises many more legal issues and economic distortions of lending than is first apparent.

Again, thank you for the opportunity to comment.

Sincerely,

EMMETT RICE.

Senator GORTON. Governor Rice, we thank you very much for your appearance here today. You've been a real help to us.

We now have a panel consisting of Mr. Ranck, Mr. Anderson, and Mr. Huddleston, if they will step forward we would be happy to hear from them.

Gentlemen, as you know from having been here, we have spent a considerable amount of time on the first three witnesses. Each of you have submitted a written statement. That written statement will be included in the record as if you read it in full. You will not read it in full. We would like you to limit your remarks to no more than 10 minutes each and gold stars will be awarded for each minute under 10 to which you can confine your statement.

Mr. Ranck, we'll let you set the example.

STATEMENT OF ROBERT RANCK, DIVISIONAL VICE PRESIDENT, CREDIT, ASSOCIATED DRY GOODS CORP.; REPRESENTING THE NATIONAL RETAIL MERCHANTS ASSOCIATION

Mr. RANCK. Mr. Chairman, members of the subcommittee, I am Robert Ranck, divisional vice president, credit department, Associated Dry Goods Corp., which is a chain of department stores, including Lord & Taylor, J.W. Robinson, Goldwater's, and many other department stores operating in 28 separate States and in the interest of being brief I do have a summary for you and we trust that our entire statement will be included as well in the record. With me today is William C. Dunkelberg, professor of economics and management at Purdue University. Professor Dunkelberg was associate director of the Credit Research Center at Purdue University from 1978–80 and he has worked as a consultant to the Federal Trade Commission and the Federal Reserve Board on economic issues relating to consumer credit.

On behalf of the National Retail Merchants Association [NRMA], I welcome the opportunity to present the views of retailing on S.

1603 and S. 1922, proposed legislation to establish limits on the rate of finance charge that may be charged on credit card accounts.

The NRMA is the Nation's leading and largest trade association for the general merchandise retailing industry. Our members operate 45,000 leading department, chain, independent, and specialty stores in all 50 States. NRMA members annual sales exceed $150 billion and although the vast majority of NRMA's members are small, independent retailers whose annual sales are less than $1 million, virtually all of NRMA's members extend credit by issuing their own credit cards or by accepting third-party credit cards.

For this reason, these hearings are of great importance to the retail industry. The proponents of these and similar bills which were the subject of hearings in the House of Representatives in 1985 are attacking what they perceive to be excessive charges by credit card issuers.

REASONS FOR NRMA'S OPPOSITION TO BOTH BILLS

NRMA's opposition to these bills is based upon fundamental principles of economics and the benefits consumers derive from a free market. These bills should not be enacted nor should they be used as the vehicle for developing revised legislation which might yield a more favorable rate structure for creditors.

The notion of a Federal ceiling on credit card rates is an unsound and inefficient regulatory measure and we will not legitimatize it or temper our opposition to it in an effort to seek a more realistic rate ceiling.

Our position is unequivocal. The proposed bills, if enacted, would have a devastating impact on credit card issuers, as well as detrimental consequences for consumers as a whole.

Our principal objections to these bills are as follows:

No. 1, we think that assuring consumer awareness and reasonable access to the marketplace, rather than ratesetting, is the proper role of Congress in regulating credit card issuers. A rate ceiling imposed by law is fundamentally inconsistent with other legislative developments in recent years on the Federal level affecting the private sector in general and affecting credit granting in particular.

Beginning with Senator Paul Douglas' introduction of the Truth-in-Lending Act in 1960, through its evolution into title I of the Consumer Credit Protection Act in 1968, and continuing through to the present time, Congress has carefully considered the best way to protect consumers in the field of consumer credit.

Experience has demonstrated that Congress was right to adopt the approach of disclosure rather than of imposition of substantive limitations upon creditors, such as ratesetting.

Consumers have the information that they need to compare creditors' terms, and creditors have demonstrated that they will compete by offering different terms, benefits, and features to their credit plans.

We believe that Government should not attempt to control the pricing of goods and services provided by the private sector as long as there are a wide variety of services offered by that industry and

as long as consumers are assured that information is available on which to base a comparison of these different products.

Both of these elements, we believe, are prevalent in the credit card marketplace today.

Two of the principal complaints of the proponents of a Federal ceiling on credit card rates are that consumers are inundated by unsolicited credit cards and that consumers do not know the cost of the card until it's too late. Both of these allegations, we believe, are unfounded, although the second contention may merit some further study. In fact, credit cards are not sent without a consumer's specific request. This practice has been prohibited under Federal law since 1971. It is only the card issuer's solicitation, inviting a customer to request a card, that is really unsolicited.

With regard to the second contention, if it can be established that consumers are not getting enough information about crucial terms of credit card plans, or that direct mail solicitations mislead consumers in some way about the cost of credit, then Congress could consider a remedy for that situation.

We would be concerned, however, that such legislation would impose unreasonable operating requirements or excessive costs upon credit card users.

Our second reason is credit card rates should not be tied to the cost of funds. The proposed legislation is precipitated by the recent decline in certain indices, such as the prime rate, without a significant corresponding decline in most credit card issuers' finance charge rates.

This legislation is based upon a number of faulty premises, one of which is that open-end credit card programs and closed-end credit are functionally the same in terms of costs and revenues. They are not.

To the contrary, there are significant differences between open-end and closed-end credit. Closed-end credit is characterized by front-end costs, including application processing, obtaining a credit bureau report, issuing a payment book and so on, which are often directly related to the short-term cost of funds. This type of credit does not involve the periodic billing statement and numerous other operating costs which are found in open-end credit.

COSTS FOR OPEN-END CREDIT ISSUERS

At Associated and most other retail companies, the typical open-end card program has many costs which are not related to the cost of funds. Credit card plans involve postal expense, data processing expense, payment processing expense, expense in monthly billing, as well as account authorization costs, and many other costs which do not necessarily follow the changes in the cost of funds and, in fact, in recent years have increased dramatically.

Another misconception is that the nominal rate disclosed by the creditor essentially is the same as the true yield to the creditor. You may be surprised to hear how small this yield is for a typical retail organization. Even at a nominal annual percentage rate of 21 percent, the true yield for retailers, who have no annual fee and no merchant discount fee, is 18 percent. This is because there is no fi-

nance charge in the first month and there is no finance charge in the last month of indebtedness.

The average retail account balance—and these issues are very balance-sensitive—the average retail account balance is $250, not $2,000—$250, and at Associated, our average balance is only $170. Therefore, a retail credit account generates less than $20 in revenue each year.

It is also important to remember that in many States retailers are limited by State law to less than 21 percent, and retailers do not have the legal right to export that rate outside of their home State, as certain financial institutions are permitted to do, to avoid these lower rate ceilings.

Point No. 3—rate ceilings that are tied to a changing index are just not workable for credit card programs. Variable rate credit plans offered by creditors should not be confused with variable rate ceilings. The former are a valid option for certain closed-end creditors and indeed have become widely accepted for certain types of long-term financing such as home mortgages. Variable rate ceilings present tremendous operational problems for retail creditors.

Keep in mind that in all likelihood the retailer does not have a variable rate plan. That is, the retailer out of operational necessity continues to offer the traditional and widely accepted flat rate plan in a variable rate ceiling State. It has not made the Federal disclosures and the extensive computer program changes that are required of the variable rate creditor. Further, in most States, a flat rate is required.

Senator GORTON. Mr. Ranck, you have used 10 minutes. Would you summarize very quickly?

Mr. RANCK. Yes, I will. I'll jump ahead to—I have two points left, Mr. Chairman.

Restrictive rate legislation results in reduced availability of credit, among other adverse consequences to consumers. If either of these bills were enacted, only the most creditworthy consumers would be granted access to credit cards because the service would have to be offered in an essentially risk-free environment. Many consumers would be excluded and forced to resort to other sources of credit such as consumer loans, the price of which would remain unregulated by this legislation.

Thus, one result of enacting this legislation would be to effectively preclude the use of credit cards by many consumers whom the legislation purports to benefit.

Credit cards are still a privilege rather than a right. Banks and retailers need not offer them if they choose not to do so and they will not offer them to a broad range of consumers if they are forced to operate under restrictive terms.

Restrictive rate regulation could force retailers to pass a higher merchant discount that would result on to all customers, cash and credit card users, in the form of higher cash prices for their goods and services and this would have the highly undesirable effect of forcing cash customers to subsidize credit card users.

Merchants who issue their own credit cards in many States cannot charge an annual fee or impose other fees such as application fees, transaction fees, or late charges. Retailers are also precluded under State laws from eliminating the free ride that per-

mits credit card users to avoid all costs of credit when they pay their bill in full each month. Thus, retailers could be forced to either abandon their own credit card plans, which would further reduce an increasingly concentrated credit card marketplace today, or extend credit only to the few who are the best credit risks.

[The complete prepared statement follows:]

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STATEMENT OF

ROBERT RANCK
VICE PRESIDENT
ASSOCIATED DRY GOODS CORPORATION

ON BEHALF OF

NATIONAL RETAIL MERCHANTS ASSOCIATION

ON

NATIONAL CREDIT CARD CONSUMER PROTECTION ACT (S. 1603)
AND
CREDIT CARDHOLDER PROTECTION ACT (S. 1922)

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
U.S. SENATE

JANUARY 28, 1986

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JAMES R. WILLIAMS
NRMA
100 West 31st Street
New York, New York

Home Office: 100 West 31st Street, New York, N.Y. 10001

Mr. Chairman, members of the Subcommittee, I am Robert Ranck, Vice President, Credit Department, Associated Dry Goods Corporation. On behalf of the National Retail Merchants Association ("NRMA"), I welcome the opportunity to present the views of retailing on S. 1603 and S. 1922, proposed legislation to establish limits on the rate of finance charge that may be charged on credit card accounts.

NRMA is the nation's largest trade association for the general merchandise retailing industry. Our members operate 45,000 leading department, chain, independent and specialty stores in all 50 states. NRMA members' annual sales exceed $150 billion, although the vast majority of NRMA's members are small, independent retailers whose annual sales are less than $1 million. Virtually all of NRMA's members extend credit by issuing their own credit cards or by accepting third party credit cards. For this reason, these hearings are of great importance to the retail industry.

The Proposed Legislation

S. 1603 would amend the Truth-in-Lending Act to provide that the annual percentage rate charged by credit card issuers may not exceed 5 percentage points over the

average investment yield on 26-week U.S. Treasury bills which were outstanding the year before.[1]

S. 1922 consists of three components. First, it would amend the Truth-in-Lending Act to provide that the annual percentage rate applicable to credit card transactions may not exceed 4 percentage points above a certain rate established under the Internal Revenue Code.[2] Second, this bill would require disclosure of the annual percentage rate and annual fees or other fees charged by credit card issuers on initial applications. Card issuers would also be required to report monthly to the Federal Reserve Board their rates and fees. Third, the bill would require the Federal Reserve Board's Consumer Advisory Council to report annually to Congress with respect to the credit card industry.[3]

Based on the indexes currently in effect, the ceiling on credit card finance charge[4] rates under S. 1603

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1. This index was 9.27% in 1983 and 10.43% in 1984.

2. This is the interest rate the Internal Revenue Service charges on late tax payments and pays on tardy tax refunds.

3. Specifically, the report would cover the costs and risks involved in issuing credit cards, the percentage of credit card customers that have their cards revoked for non-payment or delinquency, revenues from credit card operations, broken down by revenues derived from finance charges and revenues derived from annual fees and application fees, and the impact of the rate ceiling on consumers and credit card issuers.

4. The term "finance charge" is used throughout this
(footnote continued)

and S. 1922 (7.35% and 10%) would be 12.35% and 14%, respectively.

Introduction -- Retailing's Position

The proponents of these bills, and similar bills which were the subject of hearings in the House of Representatives late in 1985 (H.R. 1197 and H.R. 3408), are attacking what they perceive to be excessive charges by banks, but the legislation is directed at the rates charged by all credit card issuers. Even though there are significant differences between the way retailers and bank card issuers price the service of credit, and important distinctions between retailers and banks with respect to their cost of funds, the types and sources of revenues generated by credit cards, and the costs of operating the credit card department, these are not the principal bases for NRMA's opposition to these bills. Our position is based upon fundamental principles of economics and the benefits consumers derive from a free market, and these are the same whether the credit card is issued by a retailer or by a bank. Thus, we would oppose these bills even if they were limited

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statement rather than "interest" -- the term used in S. 1922 -- because that is the term mandated by the Truth-in-Lending Act to describe the cost of credit. "Interest" is the term associated with loan credit and is not properly used to describe credit extended by retailers and other non-lenders.

in application to bank card issuers, because they are based upon unsound economic policy.

These bills should not be enacted, nor should they be used as the vehicle for developing revised legislation which might yield a more favorable rate structure for creditors. The notion of a federal ceiling on credit card rates is an unsound and inefficient regulatory measure and we will not legitimize it or temper our opposition to it in an effort to seek a more realistic rate ceiling. Our position is unequivocal -- the proposed bills, if enacted, would have a devastating impact upon credit card issuers, as well as detrimental consequences for consumers as a whole.

Among the principal reasons why this proposed legislation should not be enacted are the following:

1. Assuring consumer awareness and reasonable access to the marketplace, not rate setting, is the proper role of Congress in regulating credit card issuers.

2. Credit card rates should not be tied to the cost of funds.

3. The legislation is based on the misconception that for many retailers revenues exceed costs attributable to their credit operations.

4. Rate ceilings that are tied to a changing index are not workable for credit card programs.

5. Restrictive rate legislation results in reduced availability of credit, among other adverse consequences for consumers.

6. Consumers have choices -- the marketplace is working.

Each of these points is discussed below.

1. Assuring consumer awareness and reasonable access to the marketplace, not rate setting, is the proper role of Congress in regulating credit card issuers.

A rate ceiling imposed by law is tantamount to legislatively fixing the price of credit services. In a free market economy, price fixing is as inappropriate and inefficient when undertaken by government as it is unacceptable when it is done by private industry. It is fundamentally inconsistent with other legislative developments in recent years on the federal level affecting the private sector in general and affecting credit granting in particular.

Beginning with Senator Paul Douglas' introduction of the Truth-in-Lending Act in 1960, through its evolution into Title I of the Consumer Credit Protection Act in 1968, and continuing up to the present time, Congress has carefully considered the best way to protect consumers in the field of consumer credit.

In 1968 Congress decided to require that all creditors provide consumers with the information necessary to compare the different terms and rates offered in connection with a wide variety of credit products. Since that time Congress has done some "fine tuning," by enacting the Truth-

in-Lending Simplification and Reform Act in 1981, and has enacted other consumer protection measures, but there is general consensus that the basic approach is as sound today as it was in 1969 when the Truth-in-Lending Act first took effect. Experience has demonstrated that Congress was right to adopt the approach of disclosure rather than imposition of substantive limitations upon creditors, such as rate setting. Consumers have the information they need to compare creditors' terms and creditors have demonstrated that they will compete by varying the terms, benefits and features of their credit plans.

Congress has repeatedly resisted the temptation to regulate the price of credit. Indeed, previously the only federal legislative restriction on the manner in which credit card plans can be priced were discounts for cash and imposition of surcharges. Both now have been eliminated. Even these limited restrictions, however, were not directed to credit rates, but rather only to the issue of whether a discount and/or surcharge should be treated as a finance charge for purposes of disclosure.

Congress has never legislated with regard to the amount of revenue a creditor should be permitted to generate

from extending credit.[5] The only exception came about when Congress acted in the area of rates because the ceilings under state law were too low, and that action was taken to remove rate ceilings in order to give consumers access to funds to purchase homes and, later, to refinance or borrow for other housing-related transactions.[6]

The proposed legislation would represent a major departure from this trend toward deregulation. It is opposite to the established wisdom that the private sector, not the government, should establish the prices charged in a competitive marketplace in this country.

Government should not attempt to control the pricing of goods and services provided by the private sector, as long as there are a wide variety of services offered by that industry and as long as consumers are assured that information is available on which to base a comparison of

5. In early 1980, the Carter Administration imposed credit controls, with highly undesirable results. Restrictions on the availability of credit cards were imposed, minimum payment schedules were increased, and numerous banks and retailers abandoned their credit card programs partially as a result of the credit control program.

6. The Depository Institutions Deregulation and Monetary Control Act of 1980 preempted state ceilings on mortgage loans and business and agricultural credit. The states were given the option of overriding the mortgage preemption within three years from enactment and the federal preemption of state ceilings on business and agricultural loans expired on April 1, 1983. In 1981, this Act was amended to expand its coverage to all lenders extending housing-related credit.

those different products. Both of these elements are prevalent in the credit card marketplace.

Two of the principal complaints of the proponents of a federal ceiling on credit card rates are that consumers are inundated by "unsolicited credit cards" and that consumers do not know the cost of the card until it is too late. Both of these allegations are unfounded, although the second contention may merit further study.

In fact credit cards are not sent without the consumer's specific request. This practice has been prohibited under federal law since 1971. It is only the card issuer's solicitation, inviting the consumer to request the card, that is unsolicited.

With regard to the second contention, if it can be established that consumers are not getting enough information about the crucial terms of credit card plans, or that direct mail solicitations mislead consumers about the cost of credit cards, Congress should remedy that situation by improving those disclosures. But that remedy does not require setting a federal ceiling on credit card rates.

It is true that direct mail and telephone solicitations that invite consumers to request a credit card often do not disclose all credit terms. This information is furnished when the card is mailed, as required by the Truth-

in-Lending Act, and the consumer is free to decline to use the card if those credit terms are not deemed satisfactory.

If the record establishes that written solicitations for credit cards are deficient or misleading, the retailing industry would not oppose legislation that was carefully drafted to remedy that situation, as long as the legislation does not impose unreasonable operational requirements or excessive costs upon credit card issuers and their customers.

2. Credit card rates should not be tied to the cost of funds.

The proposed legislation is precipitated by the recent decline in certain indexes, such as the prime rate, without a significant corresponding decline in most credit card issuers' finance charge rates.

This legislation is based upon a number of faulty premises, one of which is that open-end credit card programs and closed-end credit are functionally the same in terms of costs and revenues. To the contrary, there are significant differences between open-end credit and most closed-end credit plans. The latter are characterized by front-end costs (application processing, obtaining a credit report, issuing a payment book) which are often directly related to the short-term cost of funds. In most cases this type of

credit does not involve periodic billing statements and numerous other operating costs which are found in open-end credit. The typical open-end credit card program, on the other hand, has many costs which are not under the creditor's control and which are not related to the costs of funds. Credit card plans involve postal expenses, data processing (multiple transactions, payment processing and monthly bill preparation, to name a few), account authorization costs, and many other costs which do not necessarily follow the changes in costs of funds.

It is also important to note that the prime rate is not the proper index on which to base an estimate of the cost of funds. The cost of funds for most retailers is several points higher today than the "prime rate" because most retailers rely on long term borrowing. Even so, according to the Federal Reserve Board, during the period 1974 through 1984, financing costs averaged only 36 percent of total expenses for medium-sized bank credit card issuers. Similar results have been found for retail creditors.[7]

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7. A study of retailers' credit card costs in New York in 1973 indicated that retailers' cost of funds amounted to 40 percent of total cost of credit.

3. The legislation is based on the misconception that for many retailers revenues exceed costs attributable to their credit operations.

Proponents of a federal ceiling on finance charge rates for credit card issuers argue that creditors are reaping enormous profits. Citing the spread between today's prime rate and the nominal annual percentage rate, a spread of between 9 and 12 points (assuming a prime rate of 9% and annual percentage rates of between 18-21%), they conclude that the differential is all profit.

There are a number of misconceptions about retailers' credit card programs. First, it is thought that the nominal rate disclosed by the creditor essentially is the same as the true yield to the creditor. Second, it is thought that the costs of operating the credit card program are more than offset by revenues. Each of these points is discussed below.

Even at a nominal annual percentage rate of 21% (1.75% per month), the true yield for retailers, who do not receive revenue from annual fees and merchant discount fees, is 18%. This is because there is no finance charge in the first or last month of indebtedness.[8] When viewed in the

[8] A $100 credit card balance paid out at the rate of 21% APR over a 12 month period will yield total finance charges of $9.99, assuming minimum payments of $10.00 are made and there are no intervening purchases. This dollar amount (footnote continued)

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context of the average account balance of about $250 maintained with retailers, it can be seen that as it is paid off each account generates only about $20 in revenue each year. It is also important to remember that in many states retailers are limited by state law to less than 21%, and retailers do not have the legal right to "export" the rate authorized by their home state, as certain financial institutions are permitted to do, to avoid these lower rate state ceilings.

As noted above, retailers do not finance their receivables at the prime rate. What is more important, the costs of operating the credit card program offset the revenue generated by finance charges -- the sole source of revenue from retailers' proprietary credit cards.

NRMA recently commissioned a study of the economic characteristics of retail credit card operations by the national accounting firm of Touche Ross & Co. The final results are expected in February, 1986, but the preliminary results are now in.

The participants in the study include both large national retailers and medium size and smaller companies. As

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equals a true actuarial rate of 18% over the 1 year period of indebtedness (to be precise, $100 financed for one year at 18% actuarial interest rate yields a finance charge of $10.02).

of December 31, 1985, replies were received from 13 companies representing credit sales of slightly over $15 billion. This compares to the 15 companies included in the 1968 Touche Ross & Co. Study, which had total credit sales of $690 million.

Total finance charge revenues of the 13 companies were compared to their operating costs excluding the cost of financing the accounts receivable. A representative industry average cost of financing was then calculated to be added to the operating costs to arrive at the total cost of credit operations.[9]

To determine the cost of financing the accounts receivable to be used in the study, Touche Ross decided that a representative industry average would be the best measure, rather than the ratio for any group of participating companies. The preliminary computation shows an approximate 19% cost of financing. Using that rate, the study's preliminary results show that among the retailers surveyed costs exceeded revenue and produced a substantial deficit from credit operations. Recognizing that some might argue that a debt related rate should be used rather than a

9. The 1968 Touche Ross & Co. Study, which received wide acceptance, recognized that in order to obtain a true view of the cost of financing accounts receivable one could not use solely a debt related interest rate. It recognized that retail companies are financed in part by debt and in part by equity; therefore <u>all assets</u> are supported in part by debt and in part by equity.

weighted debt/equity rate, total costs of credit operations were calculated using a 10% rate. Even using a 10% rate, with the other amounts remaining constant, the study results show costs exceeded revenue by $130 million for the companies surveyed.

As part of the study a number of other pertinent statistics were developed. The effective finance charge rate, which is derived by dividing total finance charge revenue by average accounts receivable, equaled 16.3%. The operating costs (excluding the cost of financing) were 10.0% of average accounts receivable.

The final report will encompass 18 companies. We are informed by Touche Ross that the final results are not expected to differ significantly from the preliminary results summarized above.

4. Rate ceilings that are tied to a changing index are not workable for credit card programs.

Variable rate credit plans offered by creditors should not be confused with variable rate ceilings. The former are a valid option for certain closed-end creditors and, indeed, have become accepted practice for certain types of long-term financing, such as home mortgages. In fact, by the end of 1983, variable rate financing represented 44 percent of the loans used for home purchasing; 80 percent of

mortgage lenders now offer variable rate financing.[10] Thus, in the case of closed-end loans, lenders are able to compensate for fluctuations in the cost of funds by extending variable rate credit.

As a matter of practice, even closed-end credit retailers do not offer variable rate credit plans, for a variety of reasons. First, unlike mortgage creditors, in most states retailers operate under Retail Installment Sales Acts which do not expressly sanction variable rate credit plans. Thus, the legality of variable rate plans is unclear in many states. All retailers offer revolving credit and the disclosure and operating problems associated with offering a variable rate plan are not feasible for many retailers.

In addition, retailers believe that variable rate ceilings are a highly undesirable mechanism for controlling credit rates. A few states have chosen to change their rate structure by adopting variable rate ceilings. The ceiling is tied to an external index, such as the Federal Reserve Board discount rate in the state's district. In such cases, the ceiling is usually set at a certain number of percentage points over the index selected.

10. Survey by Federal Home Loan Mortgage Corp., summarized in Wash. Financial Reports, Vol. 42, p. 189, Jan. 23, 1984.

Variable rate ceilings present tremendous operational problems for retailers. For example, if the ceiling is set at 21% for a time and the retailer's rate is 21%, when the ceiling drops the retailer is faced with the requirement to lower its rate. Keep in mind that in all likelihood the retailer does not have a variable rate plan. That is, the retailer is offering the traditional and widely-accepted flat-rate plan -- it has not made the federal disclosures and extensive operational and computer program changes required of a variable rate creditor. Further, in most states a flat rate is required. Thus, the creditor's contract with its customers (Revolving Charge Agreement) reflects applicable state law and federal disclosure requirements. Now, when the variable rate ceiling drops the retailer is faced with several unacceptable choices. Unlike a closed-end creditor, who extends credit with each transaction at or below the rate that is permissible under the variable rate ceiling in effect at the time, the retailer extending revolving credit has to deal with a broad range of operational problems. For example:

a. Credit card issuers are required by state and federal law to disclose their periodic and annual percentage rate in the account

agreement. This pre-printed annual percentage rate will be incorrect every time the rate ceiling changes, unless the retailer places its rate so far below the variable rate ceiling that its rate won't be affected when the rate ceiling goes down.

b. The current periodic rate and corresponding nominal annual percentage rate is also required by state and federal law to appear each month on the periodic statement. Many creditors pre-print these rates on their statements. When the variable rate ceiling goes down, these pre-printed rates will be incorrect. Many small retailers do not have the capacity to computer-generate the current periodic and annual percentage rates on the monthly bill. This would mean that these small retailers would have to reprint their periodic statements each time the variable rate ceiling changes and incur extraordinary costs in order to comply.

c. Under a variable rate ceiling it is likely that retailers would be forced to apply the

current rate to all balances. This can be an unfair result, when the rate changes, because the customer and creditor both contemplated that at the time the particular purchase was made (e.g., the stove purchased when the rate was at 21%), it would be subject to the rate in effect and disclosed at that time. Even if the retailer has the legal right, under a variable rate ceiling statute, to continue to charge the higher rate in effect when the purchase was made, and this is far from clear, it would not be economically feasible to operate under a such a system. The disclosure problems, and the computer program systems changes, would make the simultaneous application of multiple rates to multiple balances a costly and burdensome task for many retail creditors.

d. Rate increases, permissible if and when the variable rate ceiling increases, also cannot be readily implemented because: (1) state and federal laws contain notice of change in terms requirements each time the rate increases

(under federal law notice of the rate increase to all affected customers is required unless the creditor has adopted a variable rate plan); (2) some states require multiple notices and advance notice of 6 months or more; (3) under contract theory the consumer is arguably entitled to continue to pay at the old rate, at least until he or she uses the account after notice of the new rate; and (4) some state laws do not permit the application of a new, higher rate to the balance that existed before the effective date of the rate increase.

The above discussion merely illustrates some of the problems that can be encountered when the legislature chooses the wrong approach to regulating rates. The wrong approach is to establish a variable rate ceiling, because it presents so many operational and legal problems that as a practical matter it is incompatible with retailers' revolving credit plans. Thus, in those few states which have adopted a variable rate ceiling (e.g., Arkansas and Texas), retail credit card issuers have been forced to treat those ceilings as fixed rate statutes, out of operational necessity, and, as

a consequence, have pegged their rates at a point well below the index in effect in each state.

5. Restrictive rate legislation results in reduced availability of credit, among other adverse consequences for consumers.

The Report of the National Commission on Consumer Finance, Consumer Credit in the United States ("Report"), issued in 1972 after three years of study by a bipartisan panel of experts representing government, academia, industry and consumers, concluded that "the effect of restrictive rate ceilings is to limit the number of borrowers who qualify for legal credit and reduce the amount of credit supplied" (Report, p. 113). The Report concluded that another result is an increase in market concentration.

Based on the indexes currently in effect, if either of these bills were enacted, unless the cost of credit is to be subsidized by merchandise price increases, only the most creditworthy consumers would be granted access to credit cards because the service would have to be offered in an essentially risk-free environment. Many consumers would be excluded and forced to resort to other sources of credit, such as consumer loans, the price of which would remain unregulated by this legislation. Thus, one result of enacting this legislation would be to effectively preclude

the use of credit cards by many of the consumers whom the legislation purports to benefit.

Credit cards are still a privilege rather than a right. Banks and retailers need not offer them if they choose not to do so and they will not offer them to a broad range of consumers if they are forced to operate under restrictive terms.

If Congress were to impose restrictive rates upon credit card issuers, the industry could adjust, but consumers would not benefit. In addition to limiting the availability of credit, those institutions that impose annual fees could increase the annual fee and impose other charges, which are not restricted by the legislation, because they are not classified as finance charges. Some of those institutions could also replace the lost finance charge revenue by increasing the merchant discount -- the fee charged the merchant for purchasing the credit card receivable. In fact this has happened in Arkansas, where the merchant discount -- 5% to 6% -- is the highest in the nation.

Retailers could make adjustments as well. Those who do not offer proprietary credit cards, but accept bank cards, could be forced to pass the higher merchant discount on to all customers -- cash and credit card users -- in the form of higher cash prices for goods and services. This

would have the highly undesirable effect of forcing cash customers to subsidize credit card users.

Merchants who issue their own credit cards in many states cannot charge an annual fee or impose other fees such as application fees, transaction fees or late charges. Retailers are also precluded under many state laws from eliminating the "free ride" that permits credit card users to avoid all costs of credit when they pay their bill in full each month. Thus, retailers could be forced to either abandon their own credit cards -- further reducing an increasingly concentrated credit card marketplace -- or extend credit only to the few who are the best credit risks. Neither result is in the best interests of consumers.

6. Consumers have choices -- the marketplace is working.

Both the bank credit card and retail credit card continue to be an excellent buy for the American consumer. When used as a convenience, retail credit cards and most bank cards can be used free of charge. There is no finance charge for purchases when the bill is paid in full each month. Indeed, when purchases are timed immediately after the buyer's billing date, the consumer is assured of nearly two months of free credit (the month during which the purchase is made and the succeeding month during which the purchase is

first billed). In fact, about one-half of a typical retailer's customers use the card as a convenience and pay their bill in full each month.[11] If the consumer chooses to pay in installments, the finance charge is calculated on the outstanding balance each month and future finance charges can always be avoided by paying the balance in full. These advantages are guaranteed under most states' credit laws.

Consumers have a wide variety of choices. In addition to using credit cards without paying finance charges, or paying in installments and controlling the amount of finance charge by varying the size of their monthly payment, consumers can also minimize credit card finance charges by using other types of credit. Personal loans, housing-related loans, check-accessed overdrafts, and other types of credit can be utilized, with a wide range of finance charge rates available. No consumer is "locked in" to a credit card rate which the consumer considers to be too high. Consumers choose to make purchases with their credit card, knowing in advance the rate charged by the credit card issuer, because they want to do so.

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11. According to a 1983 survey reported by Glenn B. Canner and Anthony W. Cyrnak, Recent Developments in Credit Card Holding and Use Patterns Among U.S. Families, Board of Governors of the Federal Reserve System, 47% of all families surveyed always pay in full. An additional 26% sometimes pay in full. Only 27% hardly ever pay in full.

In addition to a wide variety of choices among types of credit, there are significant variations in creditors' open-end credit rates. For example, in a 1985 survey of retail revolving finance charge rates in 19 deregulated states (i.e., those with no statutory ceiling) prepared by Ray McAlister, Ph.D., North Texas State University, Denton, Texas, of 519 firms surveyed 221 were charging less than 21% on all or part of the outstanding balance. Indeed, over 90% of all firms were charging 21.6% or less and 27 different rate structures were in use in the 19 states.

Although credit card issuers cannot adjust their rates with the rapidity of closed-end creditors, credit card rates are responsive to competitive pressures. Documentation of variations in rates is readily available. To name a few, for some time now The Bank of New York has been offering a rate of 17.94% on its regular Visa and Mastercard accounts and a rate of 15.96% on its preferred Mastercard. Chevy Chase Savings and Loan in Maryland offers its Visa and Mastercard customers a variable rate credit card, and the rate at present is 14%. Manufacturers Hanover, the nation's fourth largest bank, with nearly $1.4 billion outstanding in revolving credit products, recently lowered its rate from 19.8% to 17.8%.

These are but a few of an increasing number of credit card issuers that are seeking to increase their market share by competing on the basis of rate. Consumers are free to examine the various features of each card issuer's program and, if they are creditworthy, they can switch to a card offering a lower rate if the savings is deemed worth the effort.[12]

CONCLUSION

The cost of financing credit card receivables is only a portion of the total cost of extending credit. When all costs are taken into account they exceed revenue from credit for many retailers. In fact, a strong argument can be made in support of Congress adopting a course that is the opposite of these proposed bills -- the removal of all ceilings on credit.[13] A number of states have taken this action in recognition of the benefits of allowing the marketplace, rather than government, to dictate the price of this service.

12. The savings may not be worth the trouble of switching credit card issuers. For example, the savings would amount to $20 per year, or $1.66 each month, for an account with a $1000 balance, assuming a rate reduction of 2% per annum.

13. The record established in April 1983, during hearings before the Senate Banking Committee on S. 730, provides strong support for federal preemption of all state rate ceilings, including those applicable to credit card issuers.

We believe that Congress should continue to prescribe the basic, uniform standards for all citizens in areas such as disclosure of credit terms, fair credit billing, fair credit reporting, anti-discrimination, electronic funds transfer, and debt collection practices. Congress should not deviate from this proven regulatory approach. It should reject the enactment of a federal rate ceiling for any type of credit, including credit cards.

Senator GORTON. Mr. Ranck, I think we're going to have to move on to the next witness at this point.

Mr. Anderson, you're especially welcome here coming from home. We're very happy to see you.

STATEMENT OF CHARLES F. ANDERSON, SENIOR VICE PRESIDENT, RANIER NATIONAL BANK, SEATTLE, WA, REPRESENTING THE WASHINGTON BANKERS ASSOCIATION

Mr. ANDERSON. Thank you, Mr. Chairman.

My name is Charles F. Anderson. I am senior vice president of Rainier National Bank in the State of Washington. I am here today on behalf of the Washington Bankers Association and Rainier Bank to provide the subcommittee with our views of the proposed legislation for Federal limits on credit card interest rates and to clear up any faulty assumptions which may have been made with regard to the credit card rates in the State of Washington.

CURRENT RATE OF INTEREST IN WASHINGTON STATE

At the current time, the Washington legislation allows credit card interest rates to be charged at a level 4 percent above the rate for 6-month U.S. Treasury bills. However, a number of financial institutions in the State charge a rate of 15 percent based on the doctrine of the most-favored lender.

This comes about because a number of credit unions within the State are currently charging 15 percent for their credit card services.

We are afraid the subcommittee, because of the Washington interest rate controls, might assume that this situation meets with the approval of the financial institutions in the State of Washington and that it does not affect the granting of consumer credit in the State. Neither of these assumptions is true. The rates allowed under Washington State law do not allow a margin significant enough to operate profitably and to meet the consumer credit needs at the same time. In addition, it appears evident to us that the restrictive rates of our State's marketplace have caused Washington financial institutions to lose a significant share of their marketplace.

We have heard the comments and assumptions that the credit card industry represents an oligopoly, and that if a large issuer in a single marketplace were to lower rates, all in the marketplace would do the same, in order to achieve a share of that business. The assumption is that, the free market would, therefore, necessarily lower all interest rates. Frankly, our experience in the State of Washington has led us to some very different conclusions.

Washington State's three largest issuers of credit cards all operate under the controlled rates allowed by State law. And, 3 years ago, less then 10 percent of all cards issued in the State were issued by out-of-State banks. In 1985, a survey of King, Snohomish, Pierce, and Thurston Counties, which comprise about 54 percent of the State's population, showed that Washington banks had issued approximately 1.2 million cards to households in those counties and that out-of-State banks had now issued 500,000 credit cards to households in those counties. In 3 years, out-of-State banks have tripled their market share.

We're losing both business and jobs to out-of-State competition. This, despite the fact that out-of-State organizations were charging interest rates of 18 to 22 percent. That is 3 to 7 percent higher than our in-State issuers.

Our experience shows us that consumers, when accepting credit, are less interested in rates and more interested in monthly payments and add-on values which they may obtain from the out-of-State banks.

To further emphasize this, let me point out that in 1984, Rainier Bank solicited 300,000 households in nearby States, thereby pointing out to them that Washington's interest rate was below that charged by their institutions. Less than 9,000 households accepted the Rainier Bank cards.

JUSTIFICATION FOR HIGHER RATES

I hope what the members of the subcommittee can understand is this: higher rates allow the margins necessary to compete effectively, and they truly allow the consumer, at the same time, to receive those add-on values, which restrictive rates will not allow them to obtain. Certainly our experience as a Washington financial institution would bear this out.

Let me go back for just a minute and readdress my earlier comment, that the rates allowed in Washington State today will not allow us to meet the consumer credit needs of the State. With the margins provided with our current rates, it becomes necessary that we do not accept what I would consider to be normal credit risks of the credit card industry. The three largest issuers of credit cards in the State of Washington have credit criteria which state that without guarantees, they will not issue cards to consumers who have not previously had a credit rate. An interesting catch-22, which says that the first-time users of credit can't get credit cards to build that credit record, which they need to get additional credit. We restrict first-time cardholders, because, frankly, we cannot justify taking the risks of granting credit to someone who doesn't have a payment record, given our State ceiling. The risk factor requires a higher rate than our law allows.

In addition to that, the remainder of our credit criteria are so restrictive that at Rainer Bank, over the last 3 years, we have declined 59 percent, 63 percent and 61 percent respectively, of all applications we have received. It is my understanding that the decline ratios in many other States are in the 30- to 40-percent range, and certainly, below 50 percent.

Again, what I hope I'm pointing out to the subcommittee is that the rate caps have, as a result of their existence, restricted the availability of consumer credit cards issued in the State of Washington. Let me make it clear, especially about what restricted availability means to us. It means that people at lower- or moderate-income levels are not able to get credit. Credit goes to the wealthy. The lower- and moderate-income levels may get one from out-of-State institutions who do not have artificial ceilings. Artificial ceilings provide credit to those who are wealthy and tend to eliminate credit opportunities for those who need it to achieve their individual goals.

I grant you that a free-market drop in credit card rates would benefit everyone, but an artificial cap only serves to restrict the availability of credit. The members of the subcommittee, by the way, need not accept this point solely on the basis of our experience in Washington State. The Federal Reserve offered testimony last year before a House subcommittee. Likewise, studies in 1976 and 1982 by the New York State Banking Department have made this same finding.

I think we all agree that the credit card in the last 20 years has come to represent for consumers a safe, secure, and convenient means of payment. In fact, it is more of a payment system than a credit access system, and it is universally accepted. We certainly believe from our experience in Washington, and I might add that I hear the same is true of Arkansas, that rate caps are counterproductive to providing consumers a service which they want. For that reason, and the loss of jobs, our legislature even considered a bill to lift our ceiling to the market rate. It passed our Senate last year. Unfortunately, we ran out of time with regard to the House.

In summation, Mr. Chairman, let me once again make sure that no one assumes that Washington banks are pleased to operate in the restrictive credit environment that exists in their marketplace. Based on that experience, we believe that a national cap on credit card rates would actually be counterproductive.

Thank you, Mr. Chairman, for allowing me to present the views of Rainier Bank and the Washington Bankers Association. I'll be happy to answer questions at the appropriate time.

[The complete prepared statement follows:]

Rainier National Bank
General Counsel Division T18-2 One Rainier Square P.O. Box 3966 Seattle, Washington 98124 (206) 621-5946

Bruce A. Koppe
Senior Vice President

February 7, 1986

The Honorable Slade Gorton
United States Senator
Chairman, Subcommittee on Financial
Institutions and Consumer Affairs
Committee on Banking, Housing and
Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Slade:

Discussion about federal usury limits on credit cards misses a key point: People don't have to have credit cards - and they don't have to use them to have access to consumer credit! In short people don't have to pay high rates for credit; yet that is the only real argument made in support of credit card rate limits!

People don't have to pay credit card rates to get credit. There are numerous credit alternatives available at much lower rates. That's how rate-sensitive borrowers get necessary credit. Many others freely choose to pay higher rates that come with credit cards because they desire things they can't get from a personal line of credit (that is by paying only the cost of credit): Travel insurance, access to cash machines, merchant discounts, and all the other "bells & whistles" that marketers add to their credit cards.

One further point - the argument has been made that a credit card is an almost essential piece of identification to cash checks, etc. But, that still doesn't require use of the card for credit, or payment of any finance charges.

There simply is no valid argument for controlling credit card rates.

With best regards.

Sincerely,

Bruce

RAINIERBANK

Remarks by

CHARLES F. ANDERSON
Senior Vice President
Rainier National Bank
Seattle, Washington

On behalf of the
WASHINGTON BANKERS ASSOCIATION

MR. CHAIRMAN, MEMBERS OF SUBCOMMITTEE, GOOD MORNING. MY NAME IS CHARLES F. ANDERSON. I AM SENIOR VICE PRESIDENT OF THE CONSUMER SERVICES GROUP OF RAINIER NATIONAL BANK IN THE STATE OF WASHINGTON. RAINIER HAS ASSETS OF $8.3 BILLION, AND IS THE LARGEST INDEPENDENT BANK IN WASHINGTON STATE. WE OPERATE MORE THAN 130 BRANCHES, AND HAVE ISSUED MORE THAN 500,000 CREDIT CARDS, AMONG THE MOST ISSUED BY ANY ORGANIZATION IN OUR STATE. MY RESPONSIBILITIES INCLUDE ELECTRONIC BANKING AND THE BANK'S CREDIT CARD PORTFOLIO. MY CAREER INCLUDES SUPERVISION OF ELCTRONIC BANKING AND CREDIT CARD PORTFOLIOS FOR THE LAST 20 YEARS AT THREE DIFFERENT LARGE WEST COAST BANKING ORGANIZATIONS.

I AM HERE TODAY ON BEHALF OF THE WASHINGTON BANKERS ASSOCIATION AND RAINIER BANK TO PROVIDE THE SUBCOMMITTEE WITH OUR VIEWS OF THE PROPOSED LEGISLATION FOR FEDERAL LIMITS ON CREDIT CARD INTEREST RATES AND TO CLEAR UP ANY FAULTY ASSUMPTIONS WHICH MAY HAVE BEEN MADE WITH REGARD TO THE CREDIT CARD RATES IN THE STATE OF WASHINGTON.

AT THE CURRENT TIME, THE WASHINGTON LEGISLATION ALLOWS CREDIT CARD INTEREST RATES TO BE CHARGED AT A LEVEL 4% ABOVE THE RATE FOR SIX-MONTH U.S. TREASURY BILLS. IN FEBRUARY 1986 THEREFORE, THE CREDIT CARD RATE FOR OUR STATE IS 11.48%. HOWEVER, A NUMBER OF BANKS IN THE STATE OF WASHINGTON CURRENTLY CHARGE A RATE OF 15%, BASED ON THE DOCTRINE OF THE MOST FAVORED LENDER. THIS RATE OF 15% EQUALS THE RATE CURRENTLY BEING CHARGED BY SOME CREDIT UNIONS IN THE STATE OF WASHINGTON.

WE ARE AFRAID THE SUBCOMMITTEE, BECAUSE OF THE WASHINGTON INTEREST RATE CONTROLS, MIGHT ASSUME THIS SITUATION MEETS WITH THE APPROVAL OF THE FINANCIAL INSTITUTIONS IN THE STATE OF WASHINGTON AND THAT IT DOES NOT AFFECT THE GRANTING OF CONSUMER CREDIT IN THE STATE. NEITHER OF THESE ASSUMPTIONS IS TRUE. THE RATES ALLOWED UNDER WASHINGTON STATE LAW DO NOT ALLOW A MARGIN SIGNIFICANT ENOUGH TO OPERATE PROFITABLY AND TO MEET THE CONSUMER CREDIT NEEDS FOR THE STATE. IN ADDITION, IT APPEARS EVIDENT TO US THAT THE RESTRICTIVE RATES OF OUR STATE'S MARKETPLACE HAVE CAUSED WASHINGTON FINANCIAL INSTITUTIONS TO LOSE A SIGNIFICANT SHARE OF THE MARKET.

WE HAVE HEARD THE COMMENTS AND ASSUMPTIONS THAT THE CREDIT CARD INDUSTRY REPRESENTS AN OLIGOPOLY AND THAT IF A LARGE ISSUER IN A MARKETPLACE WERE TO LOWER RATES, ALL IN THE MARKETPLACE WOULD DO THE SAME IN ORDER TO ACHIEVE A SHARE OF THE BUSINESS. THE ASSUMPTION IS THAT THE FREE MARKET THEREFORE WOULD NECESSARILY LOWER INTEREST RATES. OUR EXPERIENCE IN THE STATE OF WASHINGTON WOULD LEAD US TO SOME VERY DIFFERENT CONCLUSIONS.

WASHINGTON STATE'S THREE LARGEST ISSUERS OF CREDIT CARDS ALL OPERATE UNDER THE CONTROLLED RATES ALLOWED BY STATE LAW. IN 1982, LESS THAN 10% OF ALL CARDS ISSUED IN WASHINGTON STATE WERE ISSUED BY OUT-OF-STATE BANKS. IN 1985, A SURVEY OF KING, SNOHOMISH, PIERCE AND THURSTON COUNTIES (WHICH COMPRISE 54% OF THE STATE'S POPULATION) SHOWED THAT WASHINGTON BANKS HAD ISSUED APPROXIMATELY 1.2 MILLION CARDS TO HOUSEHOLDS IN THOSE COUNTIES AND THAT OUT-OF-STATE BANKS HAD ISSUED 500,000 CREDIT CARDS TO HOUSEHOLDS IN THOSE COUNTIES. OUT-OF-STATE BANKS HAVE TRIPLED THEIR MARKET SHARE. WE'RE LOSING BUSINESS AND JOBS TO OUT-OF-STATE COMPETITION. THIS, DESPITE THE FACT THAT OUT-OF-SATE ORGANIZATIONS WERE CHARGING INTEREST RATES BETWEEN 18 AND 22%; THAT IS, 3-7% HIGHER THAN OUR IN-STATE ISSUERS. OUR EXPERIENCE SHOWS US THAT THE CONSUMER, IN ACCEPTING CREDIT, IS LESS INTERESTED IN THE RATES AND MORE INTERESTED IN MONTHLY PAYMENTS AND ADD-ON VALUES WHICH THEY MAY OBTAIN FROM THE OUT-OF-STATE BANKS. I HOPE THAT WHAT MEMBERS OF THE SUBOMMITTEE HEAR ME SAYING IS THIS: HIGHER RATES ALLOW THE MARGINS NECESSARY TO COMPETE EFFECTIVELY AND THEY TRULY ALLOW CONSUMERS TO RECEIVE THOSE ADD-ON VALUES WHICH RESTRICTIVE RATES WILL NOT ALLOW THEM TO OBTAIN. CERTAINLY OUR EXPERIENCE AS A WASHINGTON FINANCIAL INSTITUTION WOULD BEAR THIS OUT.

LET ME GO BACK AND READDRESS MY EARLIER COMMENT THAT THE RATES ALLOWED IN WASHINGTON STATE TODAY WILL NOT ALLOW US TO MEET THE CONSUMER CREDIT NEEDS OF THE STATE. WITH THE MARGINS PROVIDED, WITH OUR RATES, IT BECOMES NECESSARY THAT WE DO NOT ACCEPT WHAT I WOULD CONSIDER TO BE THE NORMAL CREDIT RISKS OF THE CREDIT CARD INDUSTRY. FOR EXAMPLE, THE THREE LARGEST ISSUERS OF CREDIT CARDS IN THE STATE OF WASHINGTON HAVE CREDIT CRITERIA WHICH STATE THAT WITHOUT GUARANTEES, THEY WILL NOT ISSUE CARDS TO CONSUMERS WHO HAVE NOT PREVIOUSLY HAD A CREDIT RATING. AN INTERESTING CATCH 22 SITUATION WHICH SAYS THAT FIRST-TIME USERS OF CREDIT CAN'T GET CREDIT CARDS TO BUILD A CREDIT RECORD. WE RESTRICT FIRST-TIME CARD HOLDERS BECAUSE WE CANNOT JUSTIFY TAKING THE RISKS OF GRANTING CREDIT TO CONSUMER WITHOUT A CREDIT RECORD, GIVEN OUR STATE CEILING. THE RISK FACTOR REQUIRES A HIGHER RATE THAN OUR LAW ALLOWS.

In addition to that, the remainder of our credit criteria is so restrictive that, at Rainier Bank, over the last three years (1983, 1984, and 1985), we have declined 59%, 63% and 61%, respectively, of the applications we received. It is my understanding that decline ratios in many other states are in the 30/40% range and certainly below 50%. Again, what I hope I'm pointing out to the subcommittee is that rate caps have, as a result of their existence, restricted the availability of consumer credit cards issued in the State of Washington. And let me be very clear about what "restricted availability" means to us. It means that people at the lower income levels don't get a credit card from Washington-based institutions, but may get one from out-of-state institutions. Artificial ceilings provide credit to those who are wealthy and tend to eliminate credit opportunities for those who need it to achieve their individual goals. To be sure, a free market drop in the credit card rates would benefit everybody. But an artificial cap only serves to restrict the availability of credit. The members of the subcommittee need not accept this point solely on the basis of our experience in Washington State. The Federal Reserve offered testimony last year before a House subcommittee, and concluded that a federal usery law would restrict credit. Likewise, studies in 1976 and 1982 by the New York State Banking Department have made the same findings.[1]

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[1] "The Impact of New York State's Usury Ceiling on Local Mortgage Lending Activity," by Ernest Kohn, Carla Carlo, and Bernard Kaye, New York State Banking Department, January 1976; and "The Price and Availability of Consumer Credit in New York State," same authors, NY State Banking Department, December 1982.

I think we will agree that the credit card in the past 20 years has come to represent for consumers a safe, secure and convenient means of payment, as well as a credit access system that is universally accepted. We certainly believe from our experience in Washington that rate caps are counterproductive to providing consumers a service which they want. For that reason, and the loss of jobs, our legislature has considered a bill to lift our ceiling to the market rate. It passed our state Senate last year, but the House Committee chairman would not consider the bill.

In summation, Mr. Chairman, let me once again make sure that no one assumes that Washington banks are pleased to operate in the restrictive credit envrionment that exists in their marketplace. And based on that experience we believe a national cap on credit card rates would be counterproductive.

Thank you Mr. Chairman for allowing me to present the views of Rainier Bank and the Washington Bankers Association. At the appropriate time I will be happy to answer any questions you may have.

SENATE BILL NO. 4113

State of Washington 49th Legislature 1985 Regular Session

by Senators McDermott, Sellar and Johnson

Read first time 2/8/85 and referred to Committee on Financial Institutions.

AN ACT Relating to credit card interest; and adding a new section to chapter 19.52 RCW.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

NEW SECTION. Sec. 1. A new section is added to chapter 19.52 RCW to read as follows:

Notwithstanding RCW 19.52.020, a financial institution in this state may charge a rate of interest on the unpaid balance of a financial institution credit card which is not greater than the interest rate that may be charged on unpaid balances of financial institution credit cards issued by any financial institution located within or without this state that issues such cards to persons residing within this state. A financial institution credit card is a card or device issued under an arrangement pursuant to which the issuing financial institution gives to a card holder residing in this state the privilege of obtaining credit from the issuer or other persons in purchasing or leasing property or services, obtaining loans, or otherwise, and the issuer of which is not principally engaged in the business of selling goods.

"Financial institution" means any bank or trust company, mutual savings bank, credit union, or savings and loan association organized pursuant to the laws of one of the United States of America or the United States of America, or the laws of a foreign country if also qualified to conduct business in any one of the United States of America, or pursuant to the laws of the United States of America.

4113

SB 4113 - S Amd
By Senator Vognsen

On page 1, line 7 after "state" insert "after July 1, 1987"

MAR 11 1985 ADOPTED

1985 CARD SOLICITATIONS
TO WASHINGTON RESIDENTS

MONTH	BANK	CARD(s)	RATE/FEE
January(3)	Seafirst	VISA/MasterCard	15%/$18
	First Nat'l Bank of Wilmington	MasterCard Gold	P+6.5%/No Fee
	Chase Manhattan	VISA	19.8%/$20
February(5)	First Deposit Savings Bank San Francisco	Select VISA	21.9%/No Fee
	First Chicago	MasterCard	19.8%/$12
	Colonial Nat'l Bank	MasterCard Gold	Priv.%/$20
	First Atlanta	VISA	18%/$12
	Citibank	Preferred VISA	19.8%/$40
March(4)	First Atlanta	VISA	18%/$12
	Citibank	VISA	19.8%/$20
	Citibank	MasterCard	19.8%/$20
	Maryland Bank	Gold MasterCard	18.9%/$30
April(7)	Associates Nat'l Bank	MasterCard	21.9%/$20
	Chase Manhattan	VISA	19.8%/$20
	U.S. Nat'l of Oregon	VISA	19.25%/$15
	*Chase Manhattan	PLC	15.75%V/$12
	Associates Nat'l Bank	VISA	19.8%/$25
	John Hancock Insurance		
	Avco National Bank	VISA	21%/No Fee
	Bank One	Super MasterCard	21.6%/$30
	Bank One	Super VISA	21.6%/$30
May(5)	Seattle-First	VISA/MasterCard	15%/$18
	Bank One	VISA	21.6%/$30
	Chase Manhattan	VISA	19.8%/$20
	Bank One	MORE VISA	21.9%/No Fee
	Citibank	VISA	19.8%/$20
June(2)	Citibank	VISA	19.8%/$20
	Citibank	MasterCard	19.8%/$20
July(6)	Citibank	VISA	19.8%/$20
	Old National Bank	VISA	15%/$18
	AVCO National Bank	MasterCard	21%/No Fee
	Chase Manhattan Bank	VISA	19.8%/$20
August(2)	Benaficial National Bank	Premium VISA	18.96%V/$2.50/MO
	US National of Oregon	VISA	19.25%/$15
	Seattle-First	VISA/MasterCard	19%/$18
September(8)	Bank One	MasterCard	21.6%/$30
	Colonial Nat'l Bank	Gold MasterCard	P + var%/$20
	Western Savings of Ariz.	VISA	18%/No Fee
	Seattle-First	REI VISA & MasterCard	15%/$18
	Citibank	Preferred VISA	19.8%/$40
	Citibank	MasterCard	19.8%/$20
	Citibank	VISA	19.8%/$20
	Bank One	Super MasterCard	21.6%/$30

Senator GORTON. Thank you. Mr. Huddleston.

STATEMENT OF RICHARD E. HUDDLESTON, SENIOR VICE PRESIDENT, INDIANA NATIONAL BANK, INDIANAPOLIS, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. HUDDLESTON. Mr. Chairman, members of the subcommittee, I am Richard Huddleston, senior vice president of the Indiana National Bank.

I am here today representing the American Bankers Association, which represents over 90 percent of commercial banks in this country. We wish to provide the subcommittee with our views on the proposed legislation for Federal limits on credit card interest rates.

Mr. Chairman, most of the recent concern over credit card rates seems to stem from the declines over the past few years in some indexes, such as the prime rate, without any across-the-board significant decline in the average credit card rate. Some view this as an indication that credit card issuers are accumulating high profits at the expense of consumers. We think, however, that an objective look at the historic level of credit card rates, the nature of the credit card market, and the array of value and components that make up a credit card clearly show this allegation to be untrue. Credit cards are and always have been a safe, secure, flexible, convenient form of credit, although expensive to offer and maintain. The cost and the inherent risk of these programs to the issuer contribute to their costly nature.

Allegations of some sort of profiteering presuppose a relatively noncompetitive market with only a few participants. This is simply not a description of the credit card marketplace today. Competition is robust; there are thousands of card issuers, millions of cards in circulation and varied entrants with new products surfacing frequently.

UNFORTUNATE EXPERIENCE OF 1980

The unfortunate experience resulting from our brief encounter with price controls in early 1980 serves as a painful reminder of the folly that results from the imposition of governmental price controls on the competitive marketplace. In the spring of 1980, we saw restrictions on the availability of credit card credit. New cards were very selectively issued. Credit qualifications were tightened. Minimum payment schedules were increased and some banks actually abandoned the business because of the burdens imposed. This contributed to a temporarily less competitive marketplace.

Mr. Chairman, it is our strong belief that these bills, however well intended, would result in significant reductions of available credit services and choices for the consumer.

We have prepared a very detailed economic analysis of the credit card marketplace, the Lexecon Study. This study, which has been previously distributed to all members of the Banking Committee, examines in great detail a number of key issues. We have attached a copy of the study to our statement and ask that it be included in the record of these hearings.

Senator GORTON. It will be part of the record.

Mr. HUDDLESTON. The market for credit card service is highly competitive. Proponents of legislation to cap credit card interest rates apparently feel that the marketplace is somehow controlled by a monopolistic group of credit card issuers; however, even a cursory examination of the facts shows that such a condition does not, indeed, could not exist, given the current market conditions. Over 15,000 institutions participate in offering VISA and MasterCard, preferably both.

The top 10 card issuers accounted for only 34 percent of all credit cards in 1984. The top 100 issues are only about 66 percent of all credit cards. The top 300 account for only 78 percent of all credit card credit. This is not a market, that by any stretch of the imagination, could be considered concentrated. The largest single credit card issuer is a retailer, who, despite its best efforts, has only 11 percent of the credit card market. The largest bank card issuer has only 4 percent of the market.

The Lexecon Study, on pages 24 through 35, provides further analysis of the credit card marketplace.

ADVANTAGES OF CREDIT CARDS

The credit card, over the past two decades, has come to represent, for consumers, a safe, secure, convenient means of payment and credit access that is accepted almost universally. It has many features which contribute to its value over and above its function as a means of access to a line of credit. It's most basic function is that of payment device, which allows access to a line of credit. Multiple purchases can be made without carrying large amounts of cash and without the inconvenience of writing a check for each purchase. It provides security and convenience. Most bank cards now also provide access to cash by national networks of automated teller machines.

Since Federal law limits losses to $50, if a card is reported lost or stolen, safety is another value of the credit card.

Credit cards also provide identification for check cashing, car rental, hotel registration, and other valuable services. And even greater value is its option of paying off all purchases when the bill comes in the mail or using the credit feature of the card to allow repayment over time. Consumers who choose to pay off every month, have the benefit of interest-free loans. Approximately one-third of card holders take advantage of this consumer float, accounting for about one-half of all total monthly volume of billings.

No matter what method is chosen, the monthly statement provides a clear accounting of all purchases, merchants, dates, and amounts for the consumer's records. All card purchases can be paid with just one check. The flexibility of the credit card is demonstrated by the existence of the option of not paying in full and exercising the credit feature of the plan. This allows consumers to decide exactly what size loan they need and for exactly how long they need it, since it can be repaid on a convenient schedule.

Given all these various benefits to the credit card, it would be more accurate to characterize the cost as a service rate rather than an interest rate. The credit card is much more than just an access device to a line of credit.

An analysis of credit card interest rates must not and cannot be conducted in the vacuum of the 1980–85 time period. This was a very unique time period in the history of our country, when interest rates, having climbed to previously unprecedented levels, declined rather significantly. As demonstrated quite graphically on the chart on page 37 of the Lexecon Study, credit card rates have remained rather steady for the past 13 years, despite fluctuations in other commonly referenced interest rate indexes.

The fact that credit card rates are and always have been higher than other rates is not at all surprising, when one considers the difference between credit card credit and traditional installment loans. First and foremost, the cost of money represents less than half the costs of operating the credit card program. In other forms of lending the cost of funds is a much larger component of the cost of the loan, usually in the 70- to 80-percent range.

This fact is not unusual, given the unique and costly aspect of the credit card operation. In a typical installment loan, such as an auto loan, the consumer fills out an application. When approved, the payment book is sent to the customer and the institution needs only to collect payments until the loan is paid off. In the credit card world, however, things are much different. There are many more behind the scenes costs of credit cards which contribute substantially to its cost. Literally billions of dollars have been spent in the worldwide communications system to allow authorization of purchases and transmission of transaction data.

Every month a statement must be issued and mailed to every credit card holder. A more detailed description of the credit card support system is attached in the appendix to my testimony.

RISKS OF CREDIT CARD SYSTEM

The point is, however, that there are unique and significant costs associated with the credit card system. If legislation, such as these bills, were enacted by Congress, the impact on consumers would be very negative, especially for the marginal credit risk, who is generally the low-income consumer and first time borrower.

The credit card business is a riskier type credit business. It is unsecured. The card holder may not have other relationships with the bank. This risk is a key factor in the rate currently charged on credit cards.

If rates are reduced, risks will have to be reduced. Those consumers which have traditionally posed the most risk, probably will have a difficult time getting credit. A number of other potential negative effects could easily result from these bills.

Other aspects of the credit card account such as annual fees, grace periods, and merchant discounts could be repriced to reflect the restriction in the supply of credit. Retailers would certainly be allowed to recoup their losses, simply by raising the price of their goods in their store. This would impact not just credit customers but all customers.

These and other adverse consequences of this type of legislation are discussed in great detail on pages 54 through 63 of the Lexecon Study.

In conclusion, Mr. Chairman, credit cards have become such an important part of our day-to-day lives, because they are so convenient, safe, flexible, useful and, in short, valuable to the American consumer. There are literally thousands of cards issued in the marketplace, providing the consumer with numerous choices. They are competing in many different ways for the consumer's business.

It is not a market that one issuer or a group of issuers could in any way control or manipulate prices of a product. Imposition of artificial controls on the price of credit cards could only serve to disadvantage consumers by limiting choice and availability of these valuable products.

Mr. Chairman, thank you for letting me present the views of the American Bankers Association on this legislation.

I'd be glad to try to answer any questions you might have.

[The complete prepared statement follows:]

October(6)	Citibank	Preferred VISA	19.8%/$40
	Chase Manhattan	MasterCard	19.8%/$20
	First Chicago	VISA	19.8%/$12
	Bank One	Super VISA	21.6%/$30
	*Chase Manhattan	PLC	14.75%V/$12
	First Chicago	Visa & Compu-Store	19.8%/$12
	Western Savings Bank	Mixed Vantage VISA	18%/No Fee
November(6)	Bank of Virginia	ASPA Silver MasterCard	19.8%/$15
	Citibank	Diner's Club	$.$75
	Chase Manhattan	MasterCard	19.8%/$20
	Dreyfus (Bank of N.Y.)	MasterCard Gold	C.D. + 6.5%/$25
	1st Nat'l Bk. of Wilmington	MasterCard Gold	P + 6.5%/No Fee
	Chase Manhattan	VISA	19.8%/$20
December	Citibank	VISA	19.8%/$20

*PLC Accounts

In-state banks are underlined

WASHINGTON BANKERS ASSOCIATION

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FIVE MAJOR WASHINGTON COMMERCIAL BANKS

A selected comparison of the effects of the 1981 usury amendments on consumer lending.**
Prepared by the Washington Bankers Association.

BANK CREDIT CARDS	FEB. 1981	AUG. 1981	CHANGE
1. Credit Applications approval rate	23%	58%	+152%
2. New Bank Card Credit Available since enactment		$278 million	NM
3. Number of Credit Line Increases		342,000	NM
4. Number of Credit Card Applications received	5,244	9,756	+ 86%
5. Credit Card Sales Volume	$ 73.5 million	$101.8 million	+ 38%
CONSUMER LOANS			
1. Personal Unsecured Credit - New Loans Interest Rate Range	$ 2.16 million	$ 4.36 million 18% - 20.7%	+101%
2. New Auto Loans Interest Rate Range	$ 3.68 million	$ 4.92 million 18.5% - 20.4%	+ 33%
3. New Boat Loans Interest Rate Range	$ 0.93 million	$ 2.6 million 18.6% - 19.3%	+179%

** In which the state's 12% usury ceiling was lifted to a floating rate, tied to six-month Treasury bills.

Statement of the
American Bankers Association
Before the
Subcommittee on Financial Institutions and Consumer Affairs
Senate Banking Committee
On
S. 1922 and S. 1603
Legislation To Limit Credit Card Interest Rates

January 28, 1986

Mr. Chairman, members of the Subcommittee, my name is Richard Huddleston. I am Senior Vice President of the Indiana National Bank, and I am here today on behalf of the American Bankers Association, which represents over 90 percent of the commercial banks in this country. We wish to provide the Subcommittee with our views on proposed legislation for federal limits on credit card interest rates.

S. 1603, as introduced by Senator Hawkins, would cap credit card rates at five percent over the average investment yield of 26-week T-Bills outstanding during the most recent twelve month period preceding January 1 of that year. S. 1922 introduced by Senator D'Amato would limit rates to four percent over the rate the IRS pays on overdue refunds. In addition, the D'Amato Bill would require disclosure of annual percentage rate and annual fee on all applications, and would require monthly reports from card issuers to the Federal Reserve Board of the APR and fees applicable to their cards.

Mr. Chairman, much of the recent concern over credit card rates seems to stem from the declines over the past few years in some indexes such as the "prime rate," without any across the board significant declines in the average credit card rate. Some view this as an indication that card issuers are garnering high profits at the expense of consumers. We think, however, that an objective look at the historic level of credit card rates, the nature of the credit card market, and the array of value components that make up a credit card, clearly show this allegation to be untrue. Credit cards are, and always have been a safe, secure, flexible and convenient form of credit, although relatively expensive to offer and maintain. The endemic costs and inherent risks of these programs to the issuer contribute to their costly nature.

Allegations of some sort of "profiteering" pre-suppose a relatively noncompetitive market with only a few participants. This is simply not a deacription of the credit card marketplace. Competition is robust: there are thousands of card issuers, millions of cards in circulation, and varied entrants with new products surfacing frequently.

Price controls such as those contained in the legislative proposals under consideration here only have the potential to be effective when a monopoly situation exists. In the monopolistic case, where providers of a product are able to impose a price on the market by controlling supply, in theory, a regulatory limit may be effective. The unfortunate experience resulting from our brief encounter with price controls in early 1980 should serve as a painful reminder of the folly resulting from the imposition of governmental price controls on a competitive marketplace. The spring of 1980 saw restrictions on the availability of credit card credit. New cards were very selectively issued. Credit qualifications were tightened. Minimum payment schedules were increased. Some banks actually abandoned the business because of the burdens imposed, thus contributing to a temporarily less competitive marketplace.

Mr. Chairman, it is our strong belief that these bills, however well intentioned, would result in a significant reduction in available credit, services and choices for consumers.

Lexecon Study

We have had prepared a very detailed economic analysis of the credit card marketplace. This study which has been previously distributed to all of the members of the Banking Committee examines in great detail a number of key areas:

* the economics of price controls in monopolistic and competitive markets,
* why and how price controls are harmful when imposed on competitive markets,
* the highly competitive nature of the credit card market and why that market is not monopolistic,
* the level and pattern of credit card interest rates as a function of the costs and other aspects of supplying that type of credit,
* the very harmful effects that imposition of this type of legislation would have on consumers.

We have attached a copy of this study to our statement and ask that it be included in the record of these hearings. My statement today will attempt to summarize some of the findings of this study, which was prepared by Lexecon, Inc., an economic research firm. I will refer to it as the Lexecon Study.

The Market For Credit Card Services Is Highly Competitive

Proponents of legislation to cap credit card interest rates apparently feel that the market place is somehow controlled by a monopolistic group of credit card issuers. However, even a cursory examination of the facts shows that such a condition does not and indeed could not exist given the existing market conditions. Over 15,000 institutions participate in offering VISA or Mastercard, usually both.

The top ten credit card issuers, accounted for only about 34 percent of all credit card credit in 1984. The top 100 issuers - only about 66 percent of all credit card credit, and the top 300 account for only about 78 percent of credit card credit.

This is not a market that by any stretch of the imagination could be considered concentrated. The largest single credit card issuer is a retailer who despite its best efforts has only eleven percent of the credit card market. The largest bank card issuer has only four percent. (See Lexecon Study, pages 24-35).

It seems that every day additional entrants announce their intention to enter the credit card field. Sears, Shell, Household International, to name just a few, are all attempting currently to promote new products. At the same time, Mastercard, VISA and other bank card issuers, are competing for the loyalty of a finite number of consumers.

In such an environment, the marketplace is a very accurate determinant of the value of the product. Any potential competitor who does not offer the appropriate value level for the cost of the product will be quickly abandoned for someone providing a better deal. As a banker involved on a day to day basis with the credit card business, I know from personal experience how well the market place is working. Legislation which would restrict our ability to compete freely would only serve to hurt the consumer by restricting the availability of a valuable array of services.

The Value Of A Credit Card Is Understood By Consumers

The credit cared over the past two decades has come to represent for consumers a safe, secure, convenient means of payment and credit access that is accepted almost universally. It has many features which contribute to

its value over and above its function as a means of access to a line of credit.

Let's take a look at an example with which I am most familiar, the bank credit card such as VISA or Mastercard. Its most basic function is that of payment device which allows access to a line of credit. Multiple purchases can be made without carrying large amounts of cash, and without the inconvenience of writing a check for each purchase. It provides security and convenience. Most bank cards now also provide access to cash via a nationwide network of automatic teller machines. Since Federal law limits losses to $50 if a card is lost or stolen, safety is another value of the credit card.

Credit cards also provide identification for check cashing, car rental, hotel registration, and other valuable services. They also allow the purchase of goods and services over the phone from far away places. This allows consumers quicker access to their purchases without having to wait for checks and order forms to travel through the mail. The dispute resolution procedure under the Federal Truth in Lending law, also provides additional protections to credit card consumers, allowing them to dispute a purchase if there is a problem with a merchant.

An even greater value is the option of paying off all purchases when the bill comes in the mail or using the credit feature of the card to allow repayment over time. Consumers who choose to pay off every month have the benefit of an interest free loan. Approximately one-third of card holders take advantage of this consumer float, accounting for about one-half of the total monthly volume of billings.

No matter what method is chosen, the monthly statement provides a clear accounting of all purchases, merchants, dates, and amounts for the consumer's records; all card purchases can be paid for with just one check. The flexibility of the credit card is demonstrated by the existence of the option of not paying in full and exercising the credit feature of the plan. This allows consumers to decide exactly what size loan they need and for exactly how long they need it, since it can be repaid on a convenient schedule.

Given all of these various benefits endemic to the credit card, it would be more accurate to characterize the cost as a "service rate" rather than an "interest rate." The credit card is much more than just an access device to a credit line.

The Level And Pattern Of Credit Card Service Rates

Any analysis of credit card interest rates must not and cannot be conducted in the vacuum of the 1980-1985 time period. This was a very unique time period in the economic history of our country when many types of interest rates, having climbed to previously unprecedented levels, declined rather precipitously. As demonstrated quite graphically on the chart on page 37 of the Lexecon Study, credit card rates have remained rather stable for the past 13 years, despite fluctuations in other commonly referenced interest rate indexes. The fact that credit card rates are and always have been higher than other rates is not at all surprising when one considers the differences between credit card credit and a traditional installment loan.

Credit Card Credit Versus Installment Credit

First and foremost, the cost of money represents less than half the cost of operating a credit card program. In other forms of lending, the cost of funds is a much larger component of the cost of the loan, usually in

the 70-80 percent range. This fact is not unusual given the unique and costly aspects of credit card operations.

In a typical installment loan, such as an auto loan, the consumer fills out an application, when approved, a payment book is sent to the customer and absent unusual circumstances, the institution needs only to collect the payments until the loan is paid off. In the credit card world, however, things are much different.

There are many more behind the scenes costs for credit cards which contribute substantially to its cost. Literally billions of dollars have been and are being spent on a world-wide communications system to allow authorization of purchases and transmission of transaction data. Every month, a statement must be issued and mailed for every credit card. A more detailed description of the credit card support systems is attached as an appendix to my testimony. The point is, however, that there are unique and significant costs associated with the credit card system.

In addition, fraud and counterfeiting have invaded the credit card business in a major and costly way. This problem has always existed to a certain extent, but in recent years a new breed of credit card criminals has developed. These criminals have specialized in obtaining valid credit card numbers and "manufacturing" counterfeit cards, or in some cases, altering the numbers on stolen cards. This problem led the industry to devote substantial resources to developing a card that was more difficult to alter. The major bank card associations have adopted hologram technology as a first step in improved card security. The hologram appears on the lower right hand corner of new VISA and Mastercards. An attempt to alter the card will result in a change in the hologram which will alert merchants to a potential problem with the card. Research into new card secure materials and procedures is an ongoing process.

In short, Mr. Chairman, there are significant additional costs which are endemic to this form of credit, that are not associated with other forms of consumer credit. These costs, however, are the result of a level of convenience and utility that is unique to the credit card.

Implications Of Rate Ceilings For Consumers

If legislation such as these bills were enacted by the Congress, the impact on consumers would be very negative, especially for marginal credit risks which generally are lower income consumers and first time borrowers. The credit card business is a riskier type of credit because it is unsecured, and the card holder may not have other relationships with the bank. This risk is also a key factor in the rate currently charged on credit cards. If rates are reduced, risks will have to be reduced. Those customers which have traditionally posed the most risk probably will have a difficult time getting credit. Mr. Anderson from the State of Washington will, I believe, be able to give the Subcommittee much more detail on conditions in Washington state where card rates are held artificially low. I think he will confirm that consumers are disadvantaged by these rate caps.

A number of other potential negative effects could easily result from these Bills:

* other aspects of the credit card account could be repriced to reflect the restriction in supply of credit (annual fees, grace periods, merchant discounts.)

* retailers would certainly be able to recoup their losses simply by raising the price of goods in their stores. This would impact not just credit customers, but all customers.

These and other adverse consequences of this type of legislation are discussed in great detail on pages 54-63 of the Lexecon Study.

Conclusion

Mr. Chairman, credit cards have become such an important part of our day-to-day lives because they are so convenient, safe, flexible, useful, in short, valuable to the American consumer. There are literally thousands of card issuers in the marketplace providing the consumer with numerous choices. They are competing in many difficult ways for the consumer's business. It is not a market where one issues or group of issuers could in any way, control or manipulate price of the product. Imposition of artificial controls on the price of credit cards could only serve to disadvantage consumers by limiting choices and availability of these valuable products.

Mr. Chairman, thank you for letting me present the views of the American Bankers Association on this legislation. I would be glad to try and answer any questions you might have.

APPENDIX

Operational Outline Of Credit Card System

For a traditional installment loan, the applicant fills out an application which is then reviewed by the loan officer, generally as part of a personal interview. A credit report may be requested, and depending on the amount, the loan officer may have the authority to approve the loan without further consultation. The bank advances the funds, a payment book is generated, and once a month the consumer sends his check to the bank or authorizes the payment amount to be deducted automatically from a checking or savings account. Every thing else being equal, there are no significant ongoing costs for that loan. After the startup costs, the processing of the monthly payment and the risk of credit extension are the only continuing costs. This contrasts markedly with the credit card system.

Application - New Accounts

The credit card application process, while essentially similar in concept to the installment loan application process, is different in two key respects, risk and volume.

Credit card applications are normally received by mail, so personal interviews with the prospective customer are not typical. This aspect of credit card programs makes them inherently more risky, since the consumer usually is not known to the bank, and the risk is one of the key elements in pricing any loan product.

The second key distinguishing factor is volume. Most bank card operations process a high volume of applications. It is a business that is built upon volume. The average bank card transaction or "loan" is only $50. The average active account makes less than 40 transactions a year. Since

over 50 percent of the dollar volume of transactions is paid off every month and never incurs a finance charge, card programs generate high volumes to defray the enormous fixed costs associated with running such an operation. Obviously, processing such a volume of applications, verifying creditworthiness, approving the application and issuing the cards can be a very labor intensive and costly process.

Upon credit approval, an account number is assigned and a master file record is established on a computer system which contains such information as the source of application, credit limit, billing cycle, issuance date, and customer information. A credit card is embossed and encoded and mailed to the cardholder along with the appropriate legal disclosures. Pre-mailers and follow-up mailers are frequently used for address verification and early detection of problems with mail theft.

Sales Transaction Authorization

Once the consumer is in possession of a valid card, he is able to take advantage of the conveniences bank cards offer. However, there are significant supporting costs which make this convenience possible.

Before a merchant may complete a transaction, authorization must often be received from the card issuing bank. Most merchants must seek such authorization if the dollar amount of the transaction exceeds the merchant's "floor limit."

Most merchants have a "floor limit" for authorizations. This limit recognizes that absent instantaneous authorization, it is not feasible or practical to require a telephone verification of each card transaction. "Floor limits" are therefore established, and transactions below that amount do not require specific authorization. These procedures recognize a certain level of risk accepted in return for consumer convenience. The costs and losses incurred due to these procedures are necessarily built into the system.

When a merchant needs an authorization, he does so by first notifying his bank. The merchant bank passes the request to the bank card authorization communications network who acts as a "switch" to contact the card issuing bank. Upon receipt of the authorization request, the issuing bank checks the current status and available credit of the account and issues either an approval or denial. Response is communicated to the merchant who completes the sale if authorized. Providing this service requires an extensive network of telecommunications and computer equipment to allow quick and accurate authorizations.

Sales Transaction Processing

The merchant accumulates paper sales receipts or captures credit card sales data electronicelly and deposits the paper credit card receipts or machine readable sales data with its bank. The merchant bank then credits the merchant's account for the value of the receipts less a discount representing a fee for processing. If the bank that originally issued the card and the bank where the merchant deposits the sales slip are the same institution, then reconciling the accounts is an easy task. However, in a great many cases, the bank where the merchant deposits its sales slips and the card issuing bank are thousands of miles apart. Therefore, a mechanism or communications network must exist to transmit the sales data from the merchant's bank to the issuing bank so it can be posted to the consumer's account.

The credit card sales data may be processed by the merchant bank itself or an agent for the bank, such as a correspondent bank or a data processing firm. Processing begins by converting the data on the sales drafts to machine readable form. Once converted, the data are transmitted to the data interchange system operated by the card company. The card company sorts the transactions by card issuing bank and calculates the dollar amount due to each merchant bank or its agent, as well as the amount due from each issuing bank. Amounts due and owed are then netted for each bank.

Cardholder Payment

Each month the cardholder receives a billing statement. The statement contains a detailed list of the charges during the month, previous balance, payments made, etc. In addition to providing this monthly statement, the issuer must establish and maintain procedures pursuant to federal law to quickly resolve any alleged errors in the billing statement. Assuming, however, that all is in order with the statement, the cardholder returns the payment stub and check which the bank microfilms, endorses, and sequentially numbers to facilitate retrieval should questions arise in the future.

As you can see, there are a great many behind the scenes people, systems and procedures that exist to make credit cards such a convenient secure payment/credit system.

Interest Rate Controls on Credit Cards --

An Economic Analysis

Lexecon Inc.

October 1985

1. Introduction and Summary

This paper, prepared for the American Bankers Association, MasterCard International Inc., and Visa U.S.A. Inc., assesses the economic merits and likely effects of the proposed national controls on credit card interest rates. Three such proposals have been introduced in the United States Congress; each would establish a floating usury ceiling ("floating" because the ceiling is determined by reference to a market rate rather than by statute or an administrative agency) for credit issued through credit cards.

H.R. 1197, introduced by Mr. Biaggi, would limit the annual rate of interest charged on "any consumer credit transaction involving a credit card" to 5 percentage points above the discount rate on 90-day commercial paper at the local Federal Reserve bank. S. 1603, introduced by Senator Hawkins, would limit interest to 5 percentage points above the percentage yield on 6-month Treasury bills during the previous calendar year. H.R. 3408, introduced by Mr. Schumer, would limit interest to 6 percentage points above the percentage yield on 3-month Treasury bills during the previous calendar quarter. The controls in the Schumer bill

would not take effect if an initial study by the Federal Reserve Board determined that credit card interest rates have reflected the costs of funds to card issuers and competition among them for new accounts.

Usury laws are among the oldest forms of government price controls, and for this reason are among the best understood in both theory and practical effect.[1] Economists have found, virtually without exception, that usury controls are either ineffective or are harmful to consumer welfare -- particularly to the welfare of those they ostensibly seek to protect.[2] Partially for this reason, and partially because recent advances in information technology have made credit markets more competitive and harder to "control" through government regulation, most state usury laws have been repealed or substantially relaxed in recent years.[3] The credit card proposals are an exception to the general trend.

The conclusions of this paper are similar to those of earlier economic studies: we find that the proposed controls are unjustified, and would be harmful to both borrowers and lenders.

The apparent basis of the proposals is that credit card interest rates are generally somewhat higher than rates for other forms of consumer and commercial credit, and have been more stable over time. In particular, rates for credit card credit have generally not declined along with rates in commercial money markets in the last few years. As we will explain, however, neither of these circumstances is appropriate cause for concern, or suggests underlying economic problems that might be resolved by government intervention.

The Federal Reserve Board study proposed in H.R. 3408 suggests a closely related concern: that the supply of credit card credit may be insufficiently competitive, leading to excessive interest rates ("excessive" meaning greater than costs of supply, including competitive returns on investments). Yet existing data amply demonstrate that the supply of consumer credit, both through credit cards and other means, is highly competitive, and that no card issuer could charge rates exceeding costs of supply except in rare and short-lived circumstances.

Forcing credit card interest rates below market-clearing levels can only create an artificial gap between the amount of credit supplied and the amount demanded -- which in turn will lead to a variety of unfortunate results, similar to those that have led to the repeal of many state interest ceilings. The most important results are likely to be:

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1. The leading scholarly account of the Biblical origins of usury restrictions, and their erosion during the Reformation, is Benjamin Nelson, The Idea of Usury (U. of Chicago Press 1969); see also Richard L. Peterson, "Consumer Finance," in George J. Benston (ed.), Financial Services (Prentice-Hall 1983) 185.

2. Contemporary studies of the economic effects of state usury laws are discussed in Section 5 of this paper.

3. According to data compiled by the American Bankers Association, of the 48 states which imposed ceilings on credit card interest rates before 1979 (California and New Hampshire did not), 19 states have since raised their ceilings and another 15 have repealed them outright.

(a) credit card issuers will adopt less efficient methods of pricing card services than they employ at present, (b) many consumers who presently finance purchases through credit card credit will be deflected to other, more costly or less convenient forms of borrowing, and (c) competition between suppliers of credit card and other forms of consumer credit will be reduced.

The credit card proposals differ from state usury controls in two important respects -- they would be applied at the national rather than state level, and would apply to only one of many forms of consumer credit. These features make the proposals particularly unpromising from an economic standpoint. Following the recent wave of interest rate deregulation, credit card credit issued by banks in states without ceilings has grown sharply relative to credit issued by banks in states that still impose ceilings. Bank cards from states with mild usury ceilings have in turn proven more popular with consumers than cards from states with strict ceilings. The least successful bank credit cards have been those issued from states that impose strict "floating" ceilings similar to those in the proposed national controls.

This market evidence is a powerful contradiction to the argument that a national ceiling on credit card interest rates would be beneficial to consumers. Consumers can already choose between controlled and uncontrolled credit cards, and they are choosing uncontrolled cards in rapidly growing numbers -- so rapidly, in fact, that credit card credit has been growing more rapidly than any other form of consumer credit. A national interest rate ceiling would deny consumers this choice. At the same time, the ceiling would not restrict other forms of consumer credit, such as installment loans from retailers and finance companies, which are substitutable for credit card credit although usually more costly and less convenient. Under the proposed national ceilings, many individuals who currently use credit card credit would be deflected to these less desirable forms of financing.

The organization of the paper is as follows. Section 2 (page 6) provides background on the organization and operation of credit card services and the recent growth in credit card and other consumer credit. Section 3 (page 19) presents a brief discussion of the economics of price controls in monopoly and competitive markets; this section shows why and how price controls are economically harmful when imposed on firms in competitive markets. Section 4 (page 24) shows that the market for credit card credit is highly competitive and free of any plausible monopoly problems; that the level and pattern of credit card interest rates is a function of the costs and other aspects of supplying such credit; and that decontrolled card credit has been more successful with consumers than controlled credit during the recent period of free consumer choice and declining money market interest rates. Section 5 (page 53) shows that the proposed national ceilings on interest rates would force rates below

market-clearing levels in many circumstances (such as the present), and describes the most likely economic consequences of the proposed ceilings.

2. Background

Devices called "credit cards" date back to early in the century. They were originally used by merchants simply to identify "regular customers," whose "credit" consisted of the right to be billed periodically for all purchases. But the modern, general purpose credit card is only about twenty years old, and would not have been possible before recent advances in data processing and communications technologies.[4] Over the past decade, credit cards have become a highly important -- and the fastest growing -- form of consumer finance in the United States.

a. How Credit Cards Operate

The defining characteristic of the modern credit card is its combination of "transaction features" with "credit features." Credit cards are widely accepted for numerous kinds of purchases in amounts running from a few dollars to several thousand dollars. In many respects cards are superior to checks or currency as a means of exchange -- for purchasing in foreign countries, for purchasing by mail or telephone, for maintaining records for tax and other purposes, and for minimizing the risk and financial cost of carrying large cash balances.

At the same time, cards carry a pre-approved line of credit against which holders may borrow at will and repay largely at their own convenience. Thus, a consumer who receives a credit card is assigned an account and a line of credit (say, $1 000) by the card issuer, and may debit purchases to that account so long as the outstanding balance does not exceed the line of credit. The cardholder generally receives a monthly statement from the issuer showing all new charges; he may elect to pay the entire amount that month, to pay a "minimum" amount that month and the rest in minimum installments in future months (stretching up to several years), or to pay any intermediate amount at any time. Unlike many other forms of consumer lending, credit card credit is unsecured: if the cardholder defaults, the card issuer is without recourse against the goods purchased with the cards.

The most widely used form of credit card is the "bank card." Bank cards are issued by commercial banks (and increasingly by other depository institutions such as savings-and-loan associations and credit unions) to both depositors and non-depositors, in both national and local

4. For a general account of the effects of technological and economic changes on the emergence of new forms of banking and finance, and the resulting erosion of traditional forms of financial regulation, see Alfred Broaddus, "Financial Innovation in the United States -- Background, Current Status and Prospects," Federal Reserve Board of Richmond, Economic Review (January/February 1985) 2.

markets. A bank card may be used for purchases from any retailer whose bank is part of the card's system for settling interbank accounts. Thus a resident of Tulsa may carry a card from a local bank (or, for that matter, a card from a bank in Oklahoma City, Chicago, or anywhere else) and use it to make a purchase in Boston. The Boston seller will take the charge slip to his local bank and receive a deposit to his account; this deposit will then be debited to the cardholder's account at the issuing bank in Tulsa through the interbank settlements system. The cardholder will be billed for the purchase in his next monthly bank statement, and may choose to pay for the purchase within the month or "on credit" over a period of months or years. If the cardholder pays for the purchase on credit, his interest payments (as well as return of principal) will be earned by his Tulsa bank, which advanced its own funds for the purchase when it originally settled accounts with the seller's bank in Boston.

There are two primary systems for settling interbank accounts -- Visa and MasterCard. These organizations operate sophisticated, world-wide payments networks among "member" banks; the two systems settle over 1.5 billion bank card transactions annually (over 4 million transactions each day). The MasterCard and Visa settlement systems are similar to those operated by the Federal Reserve System and some private firms for other interbank settlements (such as checking account settlements), but they are "paperless" and in other respects more technologically advanced.[5] Visa and MasterCard also establish rules for the operation of the settlements systems, maintain systems of account numbering, operate point-of-sale authorization systems (for purchases over certain amounts), perform research (such as on anti-fraud technologies), and provide other services to member banks.

MasterCard and Visa do not, however, control the terms of service to cardholders and sellers. Each issuing bank determines (a) the level of its interest rates and annual fees to cardholders, (b) the level of its charges to sellers (which take the form of "merchant discounts" on deposits to sellers' accounts when retail charge receipts are presented), and (c) other means of financing the costs of supplying credit card services (such as the level of "late charges" on overdue accounts). In other words, MasterCard and Visa are suppliers of settlement, authorization, and related card services to banks (and other depository institutions), and banks are suppliers of credit card services (transaction and credit services) to consumers.[6]

Banks generally charge no interest on amounts paid in the month they are billed (the so-called "free period"), and after the first month charge monthly interest at annual

5. See William F. Baxter, "Banking Interchange of Transactional Paper: Legal and Economic Perspectives," 26 J.L. & Econ. 541 (1983).

6. Indeed Visa and MasterCard do not even collect data on interest rates and other card charges from member banks.

rates which range from 12 to 21 percent but which are usually between 17 and 19 percent. Most banks charge an annual fee as well, typically about $15.[7]

Over 15,000 depository institutions -- including over 75 percent of banks with assets between $50-100 million, and over 85 percent of larger banks -- offer MasterCard or Visa cards (usually both).[8] Of these, about 3,000 banks and other institutions are "issuing banks" and the rest are "participating banks." An "issuing bank" pays service fees to MasterCard or Visa for the services described above, and determines the interest rates, other fees, and service features of cards issued to cardholders;[9] it may issue cards either directly or in collaboration with a "participating bank." A "participating bank" may provide cards (usually bearing its own name) to cardholders, but purchases card services from an "issuing bank" and adopts the card features and charges of the issuing bank's card program. Thus the issuing banks are the relevant economic units for assessing concentration and competition in the supply of bank cards. Participating banks, however, are important "intermediate consumers" between issuing banks and many cardholders -- selecting among the card programs of numerous issuing banks according to their rates and service features.

At the end of 1984, over 69 million Americans held one or more bank cards (1.9 cards per cardholder on average) and over 59 million card accounts were active monthly. Outstanding balances on bank card accounts totaled about $55 billion -- of which about $51 billion was on cards associated with the Visa and MasterCard systems.[10] Other than Visa and MasterCard cards, some banks issue their own "proprietary" cards in local markets (such as Citibank's "Choice" card in the mid-Atlantic states), and some independent firms issue credit cards through selected banks (such as American Express' "Gold Card"[11]). Local and proprietary cards are

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7. American Bankers Association, 1984 Retail Bank Credit Report 73-4.

8. Id. at 2, 62.

9. In many cases "issuing banks" are in turn members of regional bank card associations and transact with MasterCard and Visa through these associations. Here as elsewhere we use the term "banks," for purposes of convenience, to refer to all forms of depository institutions that issue general purpose credit cards.

10. Statistics from The Nilson Report, No. 347 (January 1985) 4-6. The Nilson Report is an independent bi-weekly newsletter covering developments in the credit card industry, which frequently presents statistics drawn from FRB collections and other sources. Its figures for transactions volumes and balances are generally accurate and are employed at various points in this paper. Its figures for total cardholders are rough approximations, however; administrative data collected by Visa and MasterCard suggest that over 80 million U.S. citizens currently have bank card accounts.

11. The traditional American Express "Green Card" is not, strictly speaking, a credit card because it does not include a credit line -- all accounts are payable monthly. In industry parlance this is a "travel and entertainment card." Non-credit charge cards of this sort would not be directly affected by the credit card interest rate controls as currently proposed. But these cards do permit consumers to delay payment for purchases by between one and two months (depending on the time between purchase and billing). For this reason, outstanding charge card balances are properly included in assessing the amount and supplier shares of

more likely to offer unique features such as variable or bracketed interest rates[12], rebate programs, and combinations of lower annual fees and higher interest rates or vice versa -- although many Visa and MasterCard programs offer these as well. For example, Citibank's Choice card features no annual fee and rebates for frequent users, while CoreStates Bank of Deleware offers a Visa account with a high annual fee ($50) but annual interest rates of 16.9 percent on monthly balances under $4,000 and 14.9 percent on larger monthly balances.[13]

The other major type of credit card is the "retail card" -- issued not by a bank but a retailer, and good for purchases and credit from that retailer only. There are more retail cards in circulation than bank cards (91 million Americans carried an average of 3.9 retail cards apiece at the end of 1984), but the average volume of transactions and credit is smaller, as one would expect; total outstanding balances were $46 billion at the end of 1984.[14] The most widely used retail cards are those issued by Sears, Montgomery Wards, and other large national retailers,

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11. (Cont'd.) total outstanding credit card credit, and we have done so in this paper.

12. Variable rates are rates that fluctuate with changes in specified money market rates; bracketed rates are rates that are lower for accounts with larger credit balances.

13. 1984 Retail Bank Credit Report, supra note 7; and "CoreStates Bank Offers Premium Visa Card with Lower Rate, Higher Fee," American Banker, July 11, 1985 at 16.

14. The Nilson Report, supra note 10.

but numerous local and regional stores issue credit cards as well. In addition, most of the gasoline companies issue credit cards for purchases at service stations carrying their brands. Retail and gasoline card programs do not utilize interbank settlement systems (since all purchases are made from the same company that administers the consumer billing and credit services), but are otherwise similar to bank cards in operation and pricing.[15] Currently, several of the larger issuers of retail and gas cards (such as Sears and Shell Oil) are offering cards with expanded features comparable to those of bank cards, such as acceptability for purchases from sellers other than the card issuer, no annual service fee, and rebate programs.[16]

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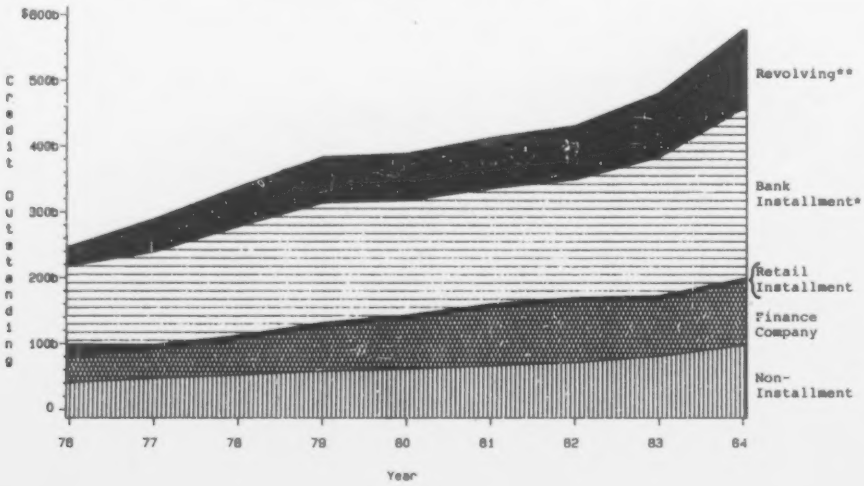
15. There is, however, one important difference in pricing, which is an artifact of state usury controls and which works to the advantage of bank cards. Interest rates for retail and gas cards are subject to the usury ceilings of the cardholder's state, while rates for bank cards are subject to the ceilings of the card issuer's state. See Marquette National Bank v. First of Omaha Service Corp 439 U.S. 299 (1978); Donna C. Vandenbrink, "Usury Ceilings under DIDMCA," Federal Reserve Bank of Chicago, Economic Perspectives (September/October 1985) 25, 26. This means that a national retailer, such as Sears, must comply with an array of different state usury ceilings, some of them quite restrictive, while a national bank card issuer, such as Citicorp, may issue unregulated cards nationwide from a state with no interest rate ceilings. As we shall see, bank cards from regulation-free states have achieved the greatest success with consumers.

16. Constance Mitchell, "Card Wars: New Credit Contenders Offer Bargains to Lure Consumers," USA Today, September 9, 1985 at 12.

Figure 1

Growth in Consumer Credit Outstanding, 1976–1984

(Credit Outstanding in Billions of Dollars)



* Includes other depository institutions such as S&Ls, credit unions, and mutual savings banks.

** Total revolving credit from banks, retailers, and gasoline companies, plus balances outstanding on charge cards.

Source: Board of Governors of the Federal Reserve System

b. The Growth of Credit Card and Other Consumer Credit

Credit card credit is not, of course, the only form of consumer credit. Banks, credit unions, and savings-and-loan associations also provide credit -- including single-payment loans, installment loans, and revolving credit -- independent of credit card accounts. Finance companies provide direct personal and consumer loans, and retailers offer a variety of installment and "lay-away" purchase plans. The three major automobile manufacturers offer a substantial amount of credit for the purchase of new automobiles through their own finance companies.

Figure 1 on the following page illustrates the growth of credit card credit and other forms of consumer credit since the mid-1970s. The area labelled "Revolving" is a close approximation of credit card credit.[17] "Bank Installment" is installment loans (other than on bank card accounts) from banks and other depository institutions; "Retailer Installment" is installment sales other than on retail credit cards; "Finance Company" is personal and consumer-goods loans from finance companies; and "Non-Installment" is all

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17. "Revolving" consists of revolving installment credit issued by banks, retailers, and gasoline companies, plus that portion of noninstallment credit consisting of amounts due on charge accounts. The revolving credit component includes a small amount of revolving credit on bank checking accounts as well as credit card accounts, but omits credit card credit on accounts at depository institutions other than commercial banks, which has been growing rapidly in recent years. The charge account component includes balances in 30-day charge accounts such as "travel and entertainment card" accounts.

Table 1

GROWTH OF BANK CARD CREDIT: 1980-85

	Credit Card Purchasing as a Percentage of Non-Housing Expenditures (All Cards)	Average Outstanding Balance per Active Account (Visa and MasterCard)	Number of Active Visa and MasterCard Accounts (millions)	Active Accounts as Percentage of Population Ages 20+ (Visa and MasterCard)	Average Line of Credit (MasterCard)
1985(2nd Q)	15.0 %	$853	68.9	41 %	$1496
1984	15.5	650	64.5	39	1457
1983	13.6	585	54.2	33	1314
1982	12.1	537	49.9	31	1284
1981	12.5	532	46.5	29	1035
1980	12.6	509	48.8	31	1028
Real Growth 1980-85(2nd Q)	+19 %	+28 %	+41 %	+29 %	+46 %

Sources: MasterCard International and Visa U.S.A./ Personal Consumption Expenditures (annual), Statistical Abstract of U.S., 1985, Table 840; Economic Report of the President, February 1985, 248-9, Table B-1, B-28; The Wilson Report, June 1985, 4-5, and Jan. 1985, 4-5.

Notes: Dollar figures deflated to 1980 levels by Consumer Price Index.

Purchasing volume (column 1) derived on basis of data showing the ratio of outstanding balances to annual purchases is 4. This implies credit dollars are turned over 2.5 times per year. Outstanding balances in these calculations reflect the sum of revolving credit balances and charge card balances.

single-payment loans other than those due in the first month on credit card and other charge accounts. "Revolving" -- primarily credit card -- credit has been the fastest growing form of consumer credit, but still accounted for only about 20% of outstanding consumer credit at the end of 1984 (about $118 billion of a total $577 billion outstanding).

The growth of credit card credit has reflected not only increased consumer spending in general but increased use of credit cards as a means of financing consumer purchases. As shown on Table 1 on the following page, credit card purchasing as a percentage of personal consumption expenditures (other than housing) grew 19 percent from 1980 through June 1985 -- from about 12.6 percent to 15 percent of expenditures. During the same period, the average outstanding balance on active Visa and MasterCard accounts increased 28 percent in real (inflation adjusted) dollars, while the average credit line on MasterCard accounts (Visa does not maintain comparable figures) increased 46 percent in real dollars. The number of active Visa and MasterCard accounts grew by 41 percent, far outstripping the 9-percent growth in the adult (20 years old and older) population.[18]

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18. The portion of bank card purchasing paid for an extended credit with interest (i.e. the portion not paid before the end of the initial one-month "free period") remained constant throughout this period at about 50 percent of the total dollar volume of purchasing. The portion of bank card accounts paying interest on credit balances increased

Two aspects of the growth in credit card use are particularly important to the analysis of this paper. The first is that the growth in accounts and in average balances per account has come at a time when prices, measured by interest rates on credit balances, have remained relatively constant (generally in the 17-19 percent range). This indicates a substantial increase in consumer demand for credit card credit, as well as an increased willingness by card issuers to extend credit -- both on an individual basis and to a larger share of the population of potential cardholders.

Second, the entire expansion in accounts has taken place since 1982; indeed the number of active accounts fell between 1979 and 1981, then increased at an annual rate of more than 9 percent after January 1982. The contraction in accounts occured during the period of very high interest rates in commercial money markets, which increased the costs of funds to card issuers; the recent expansion has coincided with a decline in the costs of funds (see Figure 4, page 37 infra). As the margin between credit card interest rates and commercial rates has grown, card issuers have expanded their demographic base -- issuing cards to population groups with higher credit risks. We shall return to these points in our discussion of credit card interest rates in Section 4.

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18. (Cont'd.) somewhat, from about 65 percent to about 70 percent. The use of extended credit on retail card accounts is apparently somewhat lower, about one-third of the dollar volume of purchasing. See discussion at pages 36-8 infra.

3. The Economics of Price Controls

Economists and other students of government regulation distinguish between price controls applied to monopoly firms and controls applied to competitive firms.[19] Firms in competitive markets cannot charge prices greater than their costs of supply, except in transitory circumstances or unless they collude on price. The reason for this is explained in detail in any good economics text,[20] but the essential logic is straightforward: (a) firms will continue to supply a product as long as the market price covers their costs of supply (including a competitive return on investment), and (b) if any individual firm attempts to charge a higher price, his customers will desert him for rival suppliers charging a lower price -- thus rewarding those who keep their prices at cost.

But a monopolist -- a firm that is the only supplier of a product for which consumers have no good substitutes -- is not under the same constraint. If he raises his price above cost, his customers cannot go elsewhere for the same product. Of course, any price increase will cause at least some consumers to purchase less of the product, so even a

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19. See, for example, Stephen Breyer, Regulation and Its Reform (Harvard U. Press 1982) 15-23, 36-70, 240-260, 285-314; Alfred E. Kahn, The Economics of Regulation (John Wiley & Sons 1970); Richard A. Posner, Economic Analysis of Law, 2d ed., (Little, Brown and Co. 1977) 193-209, 251-270.

20. Such as George J. Stigler, The Theory of Price, 3d ed., (Macmillian 1971) 176-191.

monopolist will find further price increases unprofitable at some point. In the typical case, however, the monopolist will be able to charge a price that exceeds his costs to some extent -- just how much depending on the strength of consumer demand for the product itself -- and thereby earn "supracompetitive" returns.[21]

In monopoly markets, government price controls (such as those imposed by state public utility commissions on electric and telephone companies) can contribute to economic welfare, at least in theory. If the government prescribes a price that just covers the costs of supply, consumers will receive the benefit of the lower price, and output will not be restricted because the supplier will still cover his costs; indeed output will increase, because consumers will purchase more at the lower price. Thus, the very purpose of price regulation is to achieve the full economic benefits of competitive markets in cases where (usually because of economies of scale in production) a single firm can supply the entire market most efficiently.[22]

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21. The "perfect monopoly" and the "perfectly competitive market" are of course paradigms, and firms may be able to charge prices greater than their costs in markets that are highly concentrated but less than perfect monopolies. See William M. Landes and Richard A. Posner, "Market Power in Antitrust Cases," 94 Harv. L. Rev. 937 (1981). But this is a detail for present purposes, since the degree of market concentration necessary for above-cost pricing is far greater than exists in the supply of credit card credit. See discussion at pages 25-35 infra.

22. This is not to say that price regulation in monopoly markets actually achieves this purpose. It often does not, primarily because of difficulties in making accurate determinations of costs of supply, and because even accurate cost-based regulation may distort the management incentives of regulated firms. See Kahn, supra note 19, and Richard A. Posner, "Natural Monopoly and Its Regulation," 21 Stan. L. Rev. 548 (1969).

When price ceilings are imposed on firms in competitive markets -- where prices approximate cost in the absence of controls -- and are set at below market-clearing levels, they will create a "gap" between supply and demand.[23] Consumers will demand more of the product than at the higher market price, but sellers will supply less -- either some sellers will be unable to stay in business at the controlled price, or all sellers will contract output to the point where their marginal costs of production fall to the level of the controlled price. But this is obviously an unstable situation, and both sellers and consumers will attempt to find ways to close the gap between supply and demand. With the most efficient means of doing so -- raising price until costs of supply and quantity of demand are equal -- foreclosed, there are only two ways this can be accomplished, each of them harmful to economic welfare.[24]

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23. Where price ceilings are set above market-clearing levels they will have no economic effect at all, other than the wasted expenses of monitoring and administration. We ignore this case here.

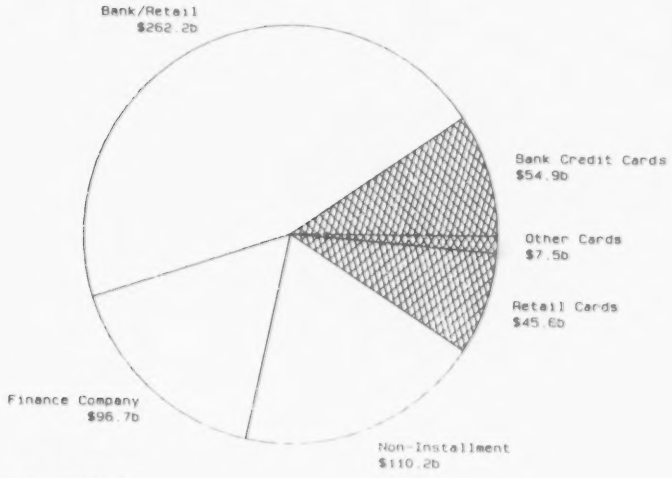
24. For a good technical accounts of the effects of price ceilings in credit markets, see James R. Ostas, "Effects of Usury Ceilings in the Mortgage Market," 31 J. Finance 821 (1976); and Donna Vandenbrink, "The Effects of Usury Ceilings," Federal Reserve Board of Chicago, Economic Perspectives (Midyear 1982) 44.

Figure 3

Credit Card Credit and Total Consumer Credit, 1984

(Credit Outstanding in Billions of Dollars)

Total Credit Outstanding = $577.1 Billion



Source: See Table 2.

Table 2

CREDIT CARD CREDIT AND OTHER CONSUMER CREDIT, 1984

		Amount outstanding (billions)	% of credit-card credit	% of consumer credit
1.	All consumer credit	$577.1		100.0 %
2.	Credit card credit	108.0	100.0 %	18.7
	a. Bank card credit	54.9	50.8	9.5
	b. Retail card credit	45.6	42.2	7.9
	c. Gas and other card credit	7.5	6.9	1.3
3.	Credit card issuers			
	a. Ten largest issuers	$ 36.8	34.0 %	6.4 %
	Sears	11.6	10.7	2.0
	Citicorp	4.4	4.1	0.8
	Montgomery Ward	4.2	3.9	0.7
	Bank of America	3.3	3.1	0.6
	American Express	3.2	3.0	0.6
	J.C. Penney	3.2	3.0	0.6
	First of Chicago	2.3	2.1	0.4
	Chemical Bank	1.6	1.5	0.3
	Chase Manhattan	1.6	1.5	0.3
	Manufacturers Bank	1.3	1.2	0.2
	b. Top 100 issuers (estimate)	$ 71	66 %	12 %
	c. Top 300 issuers (estimate)	$ 84	78 %	15 %

Source: Federal Reserve Bulletin, September 1985, Table 1.55 (p.A40); The Nilson Report, No. 347 (Jan. 1985) 4-5, No. 339 (Sept. 1984) 6-7, No. 338 (Aug. 1984) 4-5, No. 337 (Aug. 1984) 4-5.

Note: Estimates for top 100 and top 300 card issuers derived by taking sums of published outstanding balances for top 100 and 300 bank cards in 1983 and extrapolating to incorporate 1983-4 growth and non-bank credit card balances.

First, suppliers may attempt to meet the increased demand by raising their prices in ways that are not covered by the control program. The extent to which this is possible depends on the scope of the controls. For example, if interest rates on credit cards are set at below cost but annual fees are not controlled, issuers will raise their fees in an effort to meet their costs. To the extent such pricing responses are feasible, the price control program will be ineffective in reducing the actual prices faced by consumers. In fact, consumers will be worse off than before, since the new pricing system will be less efficient (more costly) than the one it replaced -- if the new pricing system were less costly it could and presumably would be introduced in the absence of the controls. Of course, it is always possible to attempt to expand the coverage of the price control program to take account of such responses, but the ways in which prices may be adjusted are almost always too various and subtle to be completely controlled. (One example, though not a subtle one, was "free toasters" for new bank depositors during the era of regulated rates on bank savings deposits). As we shall see, there are numerous repricing possibilities in the case of credit card credit.

Second, to the extent the price ceilings cannot be avoided through repricing, and thus are successful in reducing the effective prices of regulated suppliers, the result will be partial (or, in the extreme, total) withdrawal of service, for the simple reason that suppliers cannot continue in business at prices that fall below their costs. Withdrawal of service can take a variety of forms; conspicuous examples are the growth of unregulated suppliers of substitute products at the expense of regulated suppliers (money market funds before 1982), queues (gas lines during the petroleum price controls of the 1970s), and deterioration of service or product quality (railroads in the 1950s-1970s, rent controls in some cities today).[25] Where substitute, unregulated products are available, consumers will be worse off to the extent the substituted products are less desirable than the price-controlled products, in terms of price or quality or both. Where no good substitutes are available, the loss to consumers will take the form of poorer quality products and delays in obtaining them. (Delays are costly to consumers and thus may be thought of as a kind of price increase which even the most comprehensive control program cannot affect).

In either event, price controls are likely to impose not only the "deadweight" economic losses falling on all consumers and regulated suppliers, but also arbitrary redistributions of wealth and income among consumers and suppliers. For example, if suppliers have invested in

25. A few examples of the many studies documenting these effects are Steven Breyer and Paul MacAvoy, "The Natural Gas Shortage and the Regulation of Natural Gas Producers," 86 Harv. L. Rev. 941; Thomas Gale Moore, Freight Transportation Regulation (American Enterprise Institute 1972); Joseph P. Kalt, The Economics and Politics of Oil Price Regulation (M.I.T Press 1982); and Andrew S. Carron and Paul W. MacAvoy, The Decline of Service in the Regulated Industries (American Enterprise Institute 1981).

assets that are specialized in the production of the controlled product or service, these suppliers will suffer windfall losses from the control program (the MasterCard and Visa interbank settlements facilities may be examples of such specialized assets). At the same time, firms that are positioned to supply unregulated substitutes (such as, perhaps, finance companies in the case of credit card controls) may enjoy windfall gains from the sudden increase in demand for their product. Similarly, controls usually result in differential gains and losses for different groups of consumers. Rent controls produce windfall gains for those who already have long-term apartment leases, and windfall losses for those who are just entering the apartment market; gasoline lines are more harmful to those whose time is more valuable. The amount and incidence of these windfalls will vary from case to case, but in a great number of instances -- including, as we shall see, the present one -- they are not only arbitrary but perverse: harming those who are less well off and those the price controls were ostensibly designed to protect.

4. The Supply of Credit Card Credit

As explained in the previous section, the essential step in determining whether price controls might contribute to economic welfare is to determine whether the market to be regulated is a monopoly (or at least highly concentrated), so that suppliers might have the power to charge prices exceeding costs in the absence of controls. In this section, we examine the market structure of the supply of credit card credit and recent patterns in the price (interest rates) and output of this and other kinds of lending. In addition, we investigate empirical evidence on recent trends in the supply of credit card credit from states with and without interest rate ceilings on such credit, which yields insights into the potential impact of national rate ceilings on credit supply.

a. The Structure of the Market

The supply of credit card credit by banks, retailers, and others is not concentrated at all -- indeed it approaches the textbook example of an "atomistic" market -- and is intensely competitive. The possibility of above-cost pricing in the setting of interest rates and other charges can therefore be confidently rejected. While existing data do not permit a precise calibration of market shares of individual card issuers (in part because there are so many of them), they do show that even the largest issuers possess only very small market shares. A detailed Federal Reserve Board study, such as that proposed in the Schumer bill, could no doubt generate more refined data than is currently available; but it is virtually certain that the conclusion of such a study would be identical to that presented here.

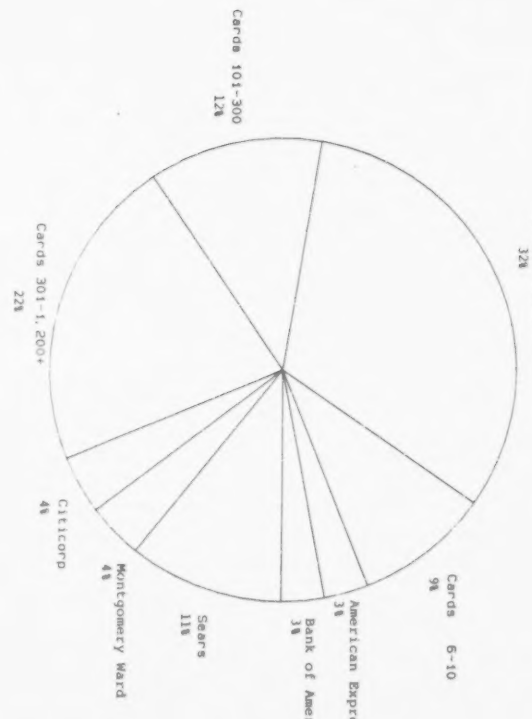
It is well to begin with the supply of credit card credit alone: although this is not, as we shall see, a separate market in economic terms, it is highly competitive

even if one entirely ignores other forms of credit available to consumers. As shown on Figure 2 on the following page, the single largest credit card issuer, Sears, accounted for only about 11 percent of all credit card balances outstanding at the end of 1984; the second largest issuer, Citicorp (which issues Visa and MasterCard cards and several proprietary and regional cards) accounted for only 4 percent.[26] The largest ten issuers accounted for only about 34 percent of credit card credit. The largest 100 issuers accounted for about 66 percent, and the largest 300 accounted for about 78 percent.

These figures indicate that, even if credit card issuers faced no competition at all from other suppliers of consumer credit, they would be faced with a high degree of competition from each other -- more than enough to resolve concerns about excessive pricing. This may be seen by reference to the "Herfindahl-Hirshman Index" ("HHI") of market concentration, which is employed widely by economists

Figure 2

Suppliers of Credit Card Credit, 1984
(Percent of Total Outstanding Credit Card Balances)



26. Exact figures are presented in Table 2 on page 35, which includes data for other forms of consumer credit as well. The market-share data on Figure 2 and Table 2 includes not only outstanding balances on true credit cards that would be regulated by the proposed interest rate ceilings, but 30-day balances on "travel and entertainment" cards (such as American Express) and other charge cards lacking a credit line. The available firm-specific data are categorized in this way, and there is analytic merit in this approach as well, as explained earlier (see note 11 supra). American Express cards, which permit purchasers to delay paying for purchases by between one and two months, obviously compete with bank, retail, and gas cards. Omitting non-credit card balances would result in a very small increase in the shares of credit balances attributed to issuers of "true" credit cards.

and is used by the courts and the Department of Justice to measure concentration and competition under the antitrust laws. The HHI is calculated by squaring the market shares of individual firms and adding them together; thus, the HHI for a market with one firm is 10,000 (100^2), for a market with four firms of equal size is 2,500 ($4x25^2$), and for a market with ten equal firms is 1,000 ($10x10^2$). The Department of Justice considers markets with an HHI of less than 1,000 to be "unconcentrated," those with an HHI of 1,000 to 1,800 to be "moderately concentrated," and those with an HHI of over 1,800 to be "highly concentrated."[27] The market concentration for credit card supply is extremely low by this measure: even if credit card issuers were the only source of consumer credit in the U.S. economy, the HHI would be about 200-225.[28]

This analysis assumes that the different types of credit cards compete with each other, and that the credit card market is nationwide rather than local. We assume it is self-evident that bank cards, retail cards, and gas cards compete directly with each other. Just as Sears, Roebuck competes with many other firms in the sale of retail merchandise, so the Sears card competes with bank cards in the sale of such merchandise on credit. Many, probably most, filling stations accept bank cards as well as those issued by their own suppliers. Moreover, even where credit cards are not substitutable as transaction devices (e.g., one generally cannot use a gas card to purchase other than automotive products on credit), the credit they supply is highly substitutable; this point is explained below in the discussion of competition between credit card and other consumer credit.

It may be objected, however, that although many hundreds of large firms and thousands of smaller ones issue credit cards in the nation as a whole, a much smaller number of firms is likely to be serving any given locality -- local banks and retailers plus several national retailers, gasoline companies, and bank card issuers. This objection is substantially unfounded, for reasons explained below, but even if it were correct it would not alter the conclusion that the supply of credit card credit is highly competitive. Observe that all of the ten largest card suppliers issue card credits nationally -- so that a citizen of (say) Washington D.C. may obtain a card from J.C. Penney and Sears as well as Hechingers and other local merchants, and from Citicorp (issuing from South Dakota), Chase Manhattan

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27. See U.S. Department of Justice, "Merger Guidelines and Accompanying Policy Statement," Antitrust & Trade Reg. Rep. (Special Supplement, June 14, 1982) ¶3. It should be emphasized that even "highly concentrated" markets may feature vigorous price competition, and there are many such markets in the U.S. economy; the Department merely uses these categories as guideposts to judge when mergers may lead to undue increases in concentration.

28. The sum of squares of the "market" shares of the largest ten credit card issuers is 185, and the tenth issuer has a market share of 1.2 percent. Thus the maximum possible HHI for all credit card suppliers -- if all remaining issuers also had 1.2 percent shares and constituted, therefore, 55 firms -- is 264. But in fact there are hundreds of additional suppliers, only a few of which have shares exceeding 1 percent, so the HHI is probably only a little over 200.

(issuing from Delaware), and Bank of America (issuing from California) as well as from Riggs Bank and other local banks. Since the ten largest firms compete in all local markets, as do many smaller national and regional banks, savings-and-loans, credit unions, and retailers, local markets remain highly competitive. For example, even if a local market was served only by the largest ten national firms plus ten other card suppliers (all of about equal shares), the HHI would still be only about 600.

But as an economic matter the market for credit card credit is in fact the national market. The purpose of analyzing market concentration is to understand pricing behavior. One wants to know whether, if one firm set prices higher than costs of supply, other firms would be in a position take business away from that firm, so that the higher price would be unprofitable. For this reason, one includes in a "relevant market" not only the firms currently serving it, but also those who would serve it if existing firms raised their prices. If a small town has only one insurance salesman, the salesman is not a "monopolist," even if everyone in town purchases insurance only from him; if he charges excessive prices, other salesmen can easily expand their territories to include the town, or townspeople can purchase their insurance from distant carriers by mail or telephone.

Thus, any local credit card market should include not only those issuers serving it at any one time, but additional issuers who could easily enter if the existing firms raised their rates above competitive levels. The number of such potential entrants is not the universe of all U.S. card issuers -- because, ironically, state usury laws make it unprofitable for many banks to seek out-of-state customers for their cards[29] -- but it is very large. The non-regulatory costs of entering a new territory are the costs of postage and supplies for a solicitation campaign, and new bank and retail cards routinely enter new regional markets far afield of their bases of operation. Indeed the emergence of nationwide credit cards is one of the most important recent developments making the provision of financial services far more competitive than it was in the past.[30]

While the supply of credit card credit is itself highly competitive, it also competes with numerous other forms of consumer credit -- that supplied by finance companies and that supplied directly by retailers, manufacturers, and depository institutions that do not offer credit card

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29. Some supporters of national credit card controls have complained that cards issued by banks in states with strict usury ceilings are not available in other states. But the reason such cards are not widely available is that it is unprofitable for banks subject to interest rate controls to issue them widely. Banks in states with low usury ceilings generally limit cards to preferred local customers who are known to them as good credit risks; banks in uncontrolled states are much more likely to issue cards nationwide. This point is discussed in detail in the last part of this section.

30. See Lee Loevinger, "Antitrust and the Banking Revolution," 9 Regulation (July/August 1985) 12.

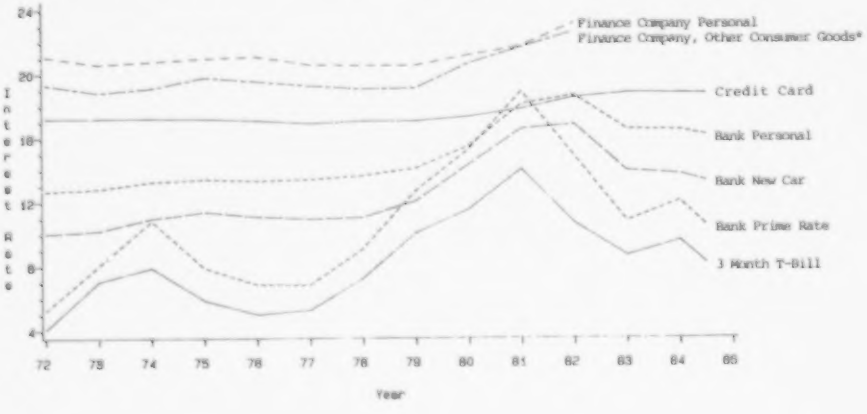
programs. In many cases the substitutability of such other forms of credit is direct and obvious; for example, one may purchase a new kitchen appliance or stereo system not only with credit card credit but with a loan from a finance company or on direct credit from the retailer. But the potential for substitution is much broader than this -- and includes forms of credit available only for items not purchased with credit cards -- because credit itself is highly fungible.

To see this, imagine that interest rates for credit card credit were set at excessive (above-cost) levels, but that rates on loans for purchasing new automobiles were competitive. Although automobiles are not ordinarily purchased with credit cards, automobile credit would nonetheless substitute for credit card credit: consumers would tend to purchase automobiles more extensively on credit, and other goods less extensively with credit card credit. Of course not all consumers would do this, but many certainly would. Virtually all consumer products (other than the smallest items) can be purchased on credit, yet only about 15 percent of purchasing is in fact made on credit card credit (see Table 1, supra page 17). This means that consumers have ample opportunities for shifting their "debt portfolios" from one category of spending to another in response to different "prices" for different categories of credit. The result is that the interest rate on one bank's credit card is constrained by rates for automobile credit in about the same way as it is constrained by rates on other credit cards. As a practical matter even home mortgages are highly substitutable for credit card credit, although we have not included mortgage borrowing in our analysis.

Figure 3 on the following page gives an approximation of the shares of consumer credit in 1984 offered by credit card issuers and other credit issuers; further detail is presented on Table 2 on the next page. According to these figures (which are slightly different than those used to construct Figure 1, supra page 15, because they are derived from a different source which includes data by card issuer), all credit card credit combined accounted for only 19 percent of outstanding consumer credit in 1984. It is not possible to estimate market shares or an HHI for the entire consumer credit market, because this would require combining card credit and non-card credit for banks and, in many cases, retailers, and the data to do this are not available. Such an exercise would tell us no more than we already know: market concentration in the supply of consumer credit, and the market shares of even the largest suppliers of credit cards, are vanishingly small.

Figure 4

Annual Movements in Consumer and Money Market Interest Rates, 1972–1985



Source: Board of Governors of the Federal Reserve System.

Notes: Beginning in 1980 48-month new car rates are used instead of 36-month, and 24-month personal loan rates instead of 12-month. The finance company series were discontinued after 1982.

* Other Consumer Goods (excludes autos and mobile homes).

b. Credit Card Interest Rates

The rate of interest on credit card credit, as measured by the Federal Reserve Board's calculations of national average rates, has remained quite constant at about 18 percent since credit cards came into widespread circulation in the early 1970s. This is shown on Figure 4 on the following page. Credit card interest rates have generally been somewhat higher and steadier than rates for other forms of consumer installment credit (secured and unsecured) available from commercial banks, but lower than rates for both secured and unsecured loans from finance companies (which were also quite stable throughout the period). Aggregate data on retail (non-card) installment credit are unavailable.

Figure 4 also displays the prime rate and percentage yields on 3-month Treasury bills for this period. These rates are considerably more volatile than rates for credit card and other consumer credit; indeed the prime rate was higher than that on credit card credit for a period in 1980 and 1981. The yield on 3-month T-bills would be the reference rate for determining interest rate ceilings under one of the proposed credit card laws. The reference rates in the other bills, 6-month T-bills rates and Federal Reserve discount rates, are generally very close to those on 3-month T-bills.

Interest rates paid by credit card borrowers are actually somewhat lower than the nominal rates, since most card issuers charge no interest during the initial one-month

"free period," and many cardholders pay their entire balances during this period. According to bank card statistics compiled by MasterCard and Visa, about 30 percent of all card accounts are paid monthly, without incurring any interest charge. Cardholders who use their cards purely as a transaction device tend use their cards more intensively (making more or larger purchases), however, so that about 50 percent of the dollar volume of credit card purchases are paid without incurring any interest. Credit dollars loaned earn interest for roughly five months on average, which suggests that 5/6 of all outstanding balances are earning interest at any point in time. Thus, an average nominal interest rate of 18 percent translates to an average effective interest rate of about 15 percent.

That credit card interest rates are higher than rates in commercial money markets is to be expected. The cost of providing credit card credit is only in part the cost of funds to the issuer. According to the Federal Reserve Board's most recent "functional cost analysis" of selected commercial banks, only 42 percent of the total costs of providing bank card services consisted of costs of funds in 1984.[30] While accounting cost calculations such as those use by the FRB are subject to numerous technical difficulties, the role of processing, debt-collection, and other administrative costs in the provision of consumer credit is well understood: these costs vary only slightly with the amount of the loan (the costs of processing a $500 loan are little different from those of a $2,000 loan), so interest rates (price as a percentage of the amount of the loan) must be higher for smaller loans in order to cover costs.[31]

That credit card interest rates are higher than rates on some other forms of consumer credit is also to the expected. Credit card credit is distinctive in many ways which affect its costs of provision. It is often extended in small amounts; it can be drawn upon without advanced notice at point-of-sale, with instant authorization from the lender for larger purchases; it can be repaid on highly flexible terms; it is made available to large and heterogeneous populations; it is unsecured. For example, bank installment loans often include individual credit investigations which are charged to the borrower as a flat fee, and which result in a credit portfolio that is of lower risk (and therefore lower cost) to the bank than the portfolio of credit card credit. Finance company loans also involve credit investigations, but are generally extended in smaller amounts and to a riskier group of borrowers than bank loans; the administrative costs per dollar of loan are presumably

30. Federal Reserve Board, Functional Cost Analysis, 1984 Average Banks (1985) 38. The cost structure of retail card credit is apparently similar: J.C. Penney's Annual Report for 1984 reports that costs of funds accounted for 50 percent of its costs of providing consumer credit.

31. See Richard L. Peterson, "Pricing Consumer Loans and Deposits," in Richard C. Aspinwall and Robert A. Eisenbeis, ed., Handbook for Banking Strategy (John Wiley & Sons 1985) 549.

higher than those for either bank installment of credit card loans. Automobile loans are highly secured, often approximating leases. One would expect, then, that interest rates on credit card credit would be considerably higher than the costs of commercial credit, would fluctuate less, and would be different (sometimes higher and sometimes lower) than rates for some other kinds of consumer credit.

Nor should it be cause for concern that credit card interest rates have generally not declined with the decline in commercial money market rates since 1981. To begin with, the stability of card rates is no indicator of "market power" on the part of card issuers, even apart from the evidence of competitive supply presented in the first part of this section. The monopolist, or other firm with market power to charge prices greater than costs, charges prices that maximize his profits -- which are a function of costs of supply and the strength of market demand. If a monopolist's costs fall, so does his profit maximizing price. So even if all credit card credit were supplied by a single firm, and consumers had no alternative sources of credit, this would not explain any of the divergence between the commercial costs of money and credit card interest rates since 1981.

The recent stability of credit card rates takes on a different light, of course, when viewed over the longer perspective of 1972 through 1985, as on Figure 4. One might as well ask why card rates were not much lower in the mid-1970s than they are today, or why they did not rise to over 25 percent in 1981. A number of plausible explanations have been offered for the recent stability of credit card rates -- such as the long-term structure of the cost of funds to banks and other large organizations, deposit interest rate deregulation, bankers' expectations that commercial rates would begin to rise sharply, and the higher costs of raising than lowering rates under "rate increase notification" regulations.[32] But surely an important part of the explanation lies in the development and growth of the credit card market and the distortions of state usury laws.

To explain, the credit card market was developing rapidly throughout the 1970s. Card issuers were accumulating large numbers of new cardholder accounts, and most states controlled interest rates through their traditional usury laws (before 1979 only two states, California and New Hampshire, did not control credit card rates, and most state

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32. See Helen J. Scott, "Interest Rates on Consumer and Commercial Loans: Why the Difference?," Congressional Research Service, Library of Congress, Report 85-818 E (May 17, 1985); Statement of Robert W. Johnson, Subcommittee on Consumer Affairs and Coinage, Committee on Banking, Finance and Urban Affairs, United States House of Representatives, Hearings on H.R. 1197 and H.R. 3408 (October 29, 1985). One explanation that is not at all plausible, however, is this one: "some consumer groups felt that banks overdid their claim to increased costs and did not reduce consumer rates in order to finance overseas loans and absorb expected large losses on these investments." Scott, op. cit. at 29. A bank or other firm cannot recoup losses in market A by raising prices in market B, regardless of whether it is a "perfect competitor" or "perfect monopolist." Assuming the firm was doing the best it could in market B before the reversals in market A, a price increase in market B will lose it money.

ceilings were set at about 18 percent). Then, in the early 1980s, the steep rise in money market rates generally made credit card programs unprofitable, since rates generally could not be increased. Partially as a result, most states relaxed or repealed their usury laws (at least as they applied to credit cards) between 1979 and 1982 (see note 3 supra). This gave many card issuers the pricing flexibility they previously lacked, but concurrently money market rates began to decline, while the demand for credit cards apparently increased. The result was that interest rates -- prices per dollar volume of credit -- neither rose nor fell; instead, card issuers greatly expanded the amount of credit they made available to individual cardholders and solicited new accounts, such as from college students and recent graduates, who were riskier (and therefore costlier) than those who had received cards earlier.

This account is strongly suggested by the data presented earlier on Table 1 (supra page 15). In 1981 and 1982, when money market rates were very high and the wave of state usury deregulation was just underway, average bank card balances and the number of bank card accounts were growing very slowly or declining; afterwards, as rate deregulation took effect and costs (at least that portion of total costs associated with costs of funds) declined, both accounts and average balances (as well as credit lines) grew dramatically.

This explanation, like the others mentioned above, is necessarily based on short-run suppositions, as any explanation of current pricing trends must be. The explanation has the virtue, however, of being consistent with economic theory and the available facts. The recent pattern of output is precisely the opposite of what one would expect if the assumptions underlying the proposed interest rate ceilings were accurate -- that is, if card issuers had been freely providing bargain credit in the early 1980s while "gouging" more recently. But it is perfectly consistent with the operation of competitive markets for firms, faced with declining costs but growing demand, to expand output and improve product quality (which is what offering larger credit lines consists of) at a constant market price.

The recent pattern may or may not persist in the future. As many observers have noted, a number of major banks, such as Manufacturers Hanover Trust and CoreStates, have recently announced substantial reductions in interest rates on their card programs. The reductions may prove unprofitable, or may auger the end of the recent period of increasing demand and expanding credit service. One can only speculate whether it will be one or the other -- but one can say with confidence that the result will be determined by the decisions of suppliers and consumers in a highly diverse and competitive credit card market.

c. The Pattern of Credit Card Growth Across States

The pattern of credit card credit across states in recent years provides further evidence of competition in the

credit card market and the potential effects of national interest rate controls. As explained earlier, interest rates on bank cards are subject to the usury laws of the card issuer's state rather than the cardholder's state (see note 15 supra). This legal regime, combined with the recent wave of usury deregulation and the fact that card programs can be administered at low cost in interstate markets, means that consumers have a wide degree of choice between various "regulated" and "unregulated" bank cards. At present, 16 states maintain "strict" interest rate controls over credit card credit (ceilings of 18 percent or lower), 17 states plus the District of Columbia maintain "moderate" controls (ceilings of higher than 18 percent), and 16 states have no controls.[33] As a result, a resident of Louisiana may obtain a credit card from a local bank, subject to that state's interest rate ceiling of 18 percent, or a card from banks in California, South Dakota, or Illinois (or other "free states"), which are subject to no rate controls and which actively solicit card accounts nationally. The Louisiana resident might also obtain a card from banks in neighboring states which impose controls looser and stricter than his own state; for example, Alabama's ceiling is 21 percent on the first $750 of credit and 18 percent on higher balances, while Arkansas' ceiling -- similar to the national ceiling proposed in the Biaggi bill -- is the lower of 17 percent or 5 percentage points over the Federal Reserve discount rate. In these cases, the Louisiana resident's choice may be limited by the business judgment of banks in the nearby states not to solicit out-of-state accounts. But to the extent this is so, it results from the state interest rate restrictions themselves, rather than from any inherent legal or economic limitations on interstate provision of credit card credit.

This state of affairs makes it possible to investigate with some precision the recent growth in credit card credit and the proposition that interest rate ceilings benefit consumers when issuers' costs of funds are declining. Since the recent wave of state usury deregulation was followed by a steep decline in money market interest rates (as shown on Figure 4, supra page 37), card credit provided by banks in states that retained interest rate ceilings should have grown relatively faster than unregulated bank card credit -- if it is correct that interest rate ceilings are beneficial to consumers. On the other hand, if the supply of bank card credit is competitive, and usury ceilings injure consumers by contracting credit availability, then unregulated credit should have grown more rapidly than regulated credit.[34]

33. Data supplied by Office of the General Counsel, American Bankers Association. The breakdown used in the analysis later in this section is slightly different, dividing states into "strict," "moderate," and "no control" categories as of the end of 1982.

34. Divergent trends in state bank card credit would fail to test the desirability of usury controls only if consumers (a) were generally unaware of bank card interest rates and (b) tended as a group to choose regulated or unregulated

The evidence demonstrates that the second proposition is correct: unregulated bank cards have done far better with consumers than regulated cards. As shown on Table 3 on the following page, revolving credit issued by banks in states with no credit card interest controls has been growing more than twice as fast as credit from banks in states with moderate and strict rate controls. In all, credit from "no control" states grew 14 percent as a portion of national revolving bank credit from 1980 through the end of 1984, while credit from "moderate control" states fell 20 percent and credit from "strict control" states fell 14 percent.

Data on revolving bank credit is, as explained earlier (at note 17 supra), only an approximation of bank card credit -- it includes balances on check revolving credit accounts, but omits balances on cards issued by depository institutions other than banks. Table 4 (page 48) therefore presents similar calculations, derived from data maintained by Visa U.S.A., for credit on Visa cards by state. The

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34. (Cont'd.) cards for some fortuitous or inexplicable reason. But federal law requires detailed and frequent disclosure of credit card and other consumer credit interest rates, and surveys show that cardholders are generally highly knowledgeable concerning card interest rates, even more so than for other forms of credit. See Statement of Robert W. Johnson, supra note 32, at 12. In addition, "participating banks" serve as intermediate consumers in many cases (see discussion at page 10-11 supra) and will have detailed knowledge of the rates charged by various issuing banks. But even if cardholders were ignorant of interest rates and unregulated banks were able to fool consumers into accepting excessively high rates, this would not explain the growth of unregulated cards relative to regulated cards documented in the text.

Table 3

GROWTH IN BANK REVOLVING CREDIT, BY STATE GROUPS, 1980-1984

	Real Growth, 1980-84	Share of U.S. Revolving Credit 1980	1984	% Change
States with No Interest Rate Controls	83.5%	54.9%	62.5%	13.8%
States with Moderate Interest Rate Controls	30.5%	21.5%	17.3%	-19.5%
States with Strict Interest Rate Controls	39.7%	23.6%	20.2%	-14.4%
(Arkansas	-4.8%	.17%	.10%	-41.2%)
All States	62.7%	100.0%	100.0%	

Source: Federal Reserve Board, Consumer Price Index, and The AECS Review No. 247-48 (June-July 1985) 18-19 (Table 6).

Note: "No control" states are AZ, CA, DE, IL, MT, NH, NJ, NM, NV, NY, OR, SC, SD, VA.

"Moderate control" states are AL, CO, DC, IA, ID, IN, KS, KY, MA, MD, ME, MS, OH, OK, RI, TN, TX, WI, WY.

"Strict control" states are AK, AR, CT, FL, GA, HI, LA, MI, MN, MO, NC, ND, NE, PA, UT, VT, WA, WV.

Breakdown is as of August 1982. Subsequently, three additional states (IA, ID, and NE) abolished rate controls on credit cards and one additional state (UT) relaxed its controls from 18 percent to a higher ceiling.

Table 4

GROWTH IN VISA CARD CREDIT, BY STATE GROUPS, 1980-1985

	Real Growth, 1980-85(2dQ)	Share of U.S. Revolving Credit 1980	1985	% Change
States with No Interest Rate Controls	135.0%	57.3%	62.0%	13.4%
States with Moderate Interest Rate Controls	81.8%	19.7%	17.3%	-12.2%
States with Strict Interest Rate Controls	58.4%	23.0%	17.7%	-23.0%
(Arkansas	11.3%	.23%	.10%	-47.8%)
All States	106.5%	100.0 %	100.0 %	

Source: Visa U.S.A. and Consumer Price Index.

Note: State breakdown same as on Table 3.

results are very similar. Visa cards issued by banks and other depository institutions in "no control" states grew at a far higher rate than those issued from states with interest rate controls, and increased their share of national credit on Visa cards by over 13 percent between 1980 and mid-1985. During the same period, cards issued from states with moderate rate controls fell 12 percent as a share of national credit on Visa cards, and cards from states with strict controls fell 23 percent. The revolving bank credit and Visa card credit results are summarized graphically on Figure 5 on the following page, which displays the relative growth in unregulated credit and relative decline in credit subject to rate controls.

Tables 3 and 4 include a separate breakout for the State of Arkansas, which has the state usury program most like those in the national proposals (as explained above), and which has often been offered as a model by proponents of national rate controls. Arkansas did far worse even than other "strict control" states, and was near the bottom of all states in all comparisons. Revolving credit issued by Arkansas banks actually declined in real terms between 1980 and the end of 1984; only Kentucky banks did worse. Visa card credit issued by Arkansas banks grew only slightly, 11 percent over a period of 4 1/2 years. This was less than anywhere else in the nation except for two states where Visa credit declined in real terms: Louisiana, which has a flat 18-percent usury ceiling, and Alaska -- the only other state

with a "floating" usury ceiling similar to those in the proposed national ceilings.

This market evidence is unambiguous: as money market rates have fallen, unregulated card credit has become increasingly more successful with consumers than credit subject to interest rate ceilings. Card credit subject to moderate ceilings has in turn been more successful than credit subject to strict ceilings, and card credit subject to strict "floating" ceilings has been least successful of all.

This is not to say, of course, that consumers prefer higher interest rates (or other prices) to lower ones, other things being equal. To the contrary, it is because consumers prefer lower prices that we know other things must not be equal in the present case.[35] The relative success of unregulated cards must be due to their superior quality, measured by both service features and availability. Banks from states with no usury controls appear to be the most aggressive marketers of bank cards -- offering a variety of different cards with features appealing to different

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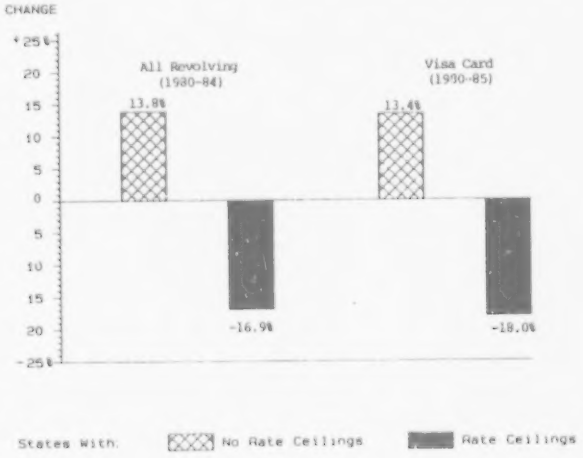
35. Actual interest payments may not vary that much from state to state, however, which strengthens our conclusions. Interest rates may not be much different between unregulated bank cards and those subject to moderate controls; notice that the recent rate reductions, such as those announced by CoreStates and Manufacturers Hanover, appear to be primarily by banks whose card interest rates are not regulated. Even where rate differences are substantial (as between unregulated cards and those in the strictest control states) the absolute difference in finance charges paid by cardholders may not be large.

Figure 5

Changes in State Shares of Credit Card Credit, 1980–1984/85



Source: Federal Reserve Board and Visa U.S.A.

groups of consumers, advertising their cards nationwide, and soliciting new cardholders among riskier demographic groups such as students, individuals of modest means, individuals with no credit history, etc. Banks from states with strict controls, on the other hand, appear to be highly restrictive in issuing cards -- limiting them, for example, to longstanding local depositors and executives with firms that do business with the bank.

Some evidence of this is presented on Table 5 on the following page, showing the "credit charge-off rate" (i.e., the percentage of credit volume written off as bad debt) for Visa cards in our three categories of states. While the charge-off rate is quite low in all states, it is substantially higher in states without interest rate controls than in states with controls. This indicates that unregulated bank card programs are much more likely to take business risks in order to supply cards to a greater number of consumers, and that regulated programs are more likely to restrict access to well-known customers. The charge-off rate for banks in states with the tightest ceilings (approximating those in the proposed national laws) approaches zero (in 1984 it was .43 percent for Arkansas and .07 percent for Alaska) -- suggesting that banks operating under these conditions can afford to provide credit only to a very few select individuals.

Table 5

VISA CHARGE-OFFS AS PERCENT OF TOTAL PURCHASES, BY STATE GROUPS, 1984

States With No Interest Rate Controls	1.38 %
States With Moderate Interest Rate Controls	.89 %
States With Strict Interest Rate Controls	.85 %
All States	1.18 %

Source: Visa U.S.A.

Note: Charge-off data are for bad debt only and do not include charge-offs for fraud.

State breakdown same as on Table 3.

5. The Effects of a National Interest Rate Ceiling

The national interest rate ceilings currently under consideration in the Congress, which would float at 5 or 6 percentage points above rates in commercial money markets, would be seriously binding on credit card credit in many circumstances. For example, during the period charted on Figure 4 (supra page 37) such ceilings would have forced interest rates to below market levels for ten of the thirteen years shown (excluding the period from 1979-82). The current ceiling rate would be in the 12-13 percent range -- about that currently charged for secured loans on new automobiles. This is more than one-third lower than the current average market rate for credit card interest, and lower than rates in all but a few states, where card credit is severely restricted.

Notice that one could not select a "better" average ceiling -- say one that was "too tight" just about as often as it was "too loose" -- and expect that the two kinds of errors would cancel out in the long run. The economic consequences of the binding ceilings in the "too tight" years could not be compensated for in the "too loose" years, since market competition would keep rates at cost whenever the floating ceiling was above market levels. Even in monopoly markets, price controls that are set too low and too high do not compensate, since the output of the regulated firm is restricted in both cases.

The first effect of a binding national rate ceiling would be an increase in the demand for credit cards and a decrease in their supply. Card issuers would attempt to adjust to the increased demand by increasing their prices in ways not covered by the national controls. One obvious alternative would be to raise annual fees. Others would be to eliminate the initial "free period" on card accounts and, in the case of bank cards, to increase the merchant discount (the fee charged to retailers against their credit card sales).

The national controls could be, of course, expanded to cover these aspects of credit pricing, and in fact a few states already control cardholder fees, free periods, and merchant discounts. There would, however, be numerous additional repricing opportunities that would be much more difficult to monitor or control. Card issuers could revise their procedures for clearing and posting card charges so as to initiate both the free and interest periods earlier; could establish new or additional charges for initial credit checks, account inquiries, and late payments; and could require some or all applicants to purchase credit insurance at their own expense (as is often done for non-card consumer loans). Sears, Roebuck and other retailers could raised product prices to all customers (about half of Sears purchases are made on its credit card), or raise prices on those products most frequently purchased on credit. Such changes in product prices would be economically equivalent to an increase in

the merchant discount on bank cards, but would be far more difficult to monitor and control, and presumably would be considered beyond the appropriate scope of an interest rate scheme.

Pricing adjustments such as these would have different effects on different cardholders and card issuers, but their net effect on economic welfare would be negative. For example, it seems likely that Sears and other large retail card issuers would be in a better position than independent retailers to reprice products in response to interest rate controls -- because, as just mentioned, there is no independent market transaction (the bank card merchant discount) to be monitored and controlled in the case of retail cards. For this reason and others (see discussion at note 15 supra), national credit card controls would probably be less harmful to retail cards than to banks cards.[36] For another example, consider that some cardholders (such as frequent borrowers) would prefer cards with higher annual fees and lower interest rates, such as national rate controls would probably promote.

In both cases, however, consumers as a whole would be worse off, even though some would do better than others. Consumers do not gain when one group of sellers (large national retailers) gains an advantage over another group (smaller retailers) solely because of a superior ability to adjust to price controls. Some widely marketed bank cards already offer higher annual fees and lower interest rates (see note 13 supra), so consumers who prefer this option can obtain it with or without rate ceilings; consumers who prefer lower fees and higher rates, however, could not obtain their own preferred option with rate ceilings. The general point is straightforward: pricing systems adopted solely in response to government controls on one aspect of price are certain to be less efficient, and to have arbitrary distributive effects among different groups of suppliers and consumers.

Although one can envision numerous possibilities for repricing credit card services, it is unlikely that such adjustments could close the gap between demand and supply created by a binding national rate ceiling. This conclusion is suggested by the evidence presented in the previous section on bank card growth in states with different usury policies. If credit cards could be completely repriced in response to usury ceilings, cards issued from controlled states could replicate the prices of uncontrolled cards and one would expect to see no systematic pattern between card credit from the two groups of states. That one instead sees a considerable divergence -- even between uncontrolled states and states with "moderate" ceilings only slightly below market interest rates -- suggests that the

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36. Indeed it is conceivable, though unlikely, that large national retailers would be net beneficiaries of national interest rate controls, by gaining market shares from smaller retailers who currently rely on bank cards and from bank card issuers who are currently freer of state usury controls than retail cards.

opportunities for repricing are not very substantial as a practical matter. Either the inefficiencies of repricing are greater than the benefits (a pricing change may increase revenues x percent per account but lose more than x percent of accounts), or there are important competitive restraints on repricing (competition from charge cards such as American Express may restrict the ability of bank cards to eliminate their "free periods," for example).[37]

It is likely, therefore, that national rate controls would produce the more serious economic effects suggested in Section 3 -- a contraction in the availability of credit card credit, partially compensated by the expansion of other forms of credit which are more costly or less convenient (or both) but are unregulated. The contraction of card credit can be expected to be similar to that which has already occurred in states with strict rate ceilings. Depending on the stringency of the national controls, bank card issuers would withdraw from marketing card services on a nationwide basis, would withdraw from marketing to riskier demographic groups such as students and individuals with lower incomes, or would restrict their card programs to preferred customers such as longstanding depositors and executives of client firms. All of these actions could, and in one way and another would, close any gap between supply and demand remaining after feasible repricing opportunities had been exhausted; they would do so by reducing the costs of supplying credit card credit and increasing the costs of obtaining it.

In the case of the state interest rate ceilings examined in Section 4, the relative decline in credit from controlled states probably had little effect on total outstanding card credit nationally or even in the controlled states -- since such a large amount of card credit was readily available from uncontrolled states. But under a binding national rate ceiling this response will be impossible, so the resulting decline (relative or absolute) in credit card credit will be made up, where possible, by growth in other kinds of consumer credit. Consumer credit is highly substitutable, for reasons explained in Section 4, and studies of state usury controls have shown that even very broad controls often have little effect on the total amount of credit used by consumers.[38] Thus, an obvious means of contraction for

37. This is not to say that that issuers cannot reprice at all. There is recent evidence, for example, that Arkansas banks tie the sale of consumer loans more closely to other, deposit services, and charge higher service and overdraft fees on deposit accounts, than banks in states with no usury restrictions. A. Charlene Sullivan, "Evidence of the Effect of Restrictive Loan Rate Ceilings on Prices of Consumer Financial Services," Working Paper No. 36, Credit Research Service, Krannert Graduate School of Management, Purdue University (hereafter Credit Research Center) (1980). The point, rather, is that opportunities for repricing are sufficiently limited that national interest rate controls are likely to produce other, non-price responses.

38. For example, even when Arkansas maintained a comprehensive 10-percent interest rate ceiling, it appeared to have little effect on the total amount of credit used by consumers in the state. Consumers relied much more heavily on direct retail credit (where retailers could offer loans at the usury ceiling and finance the true cost of the loans by raising product prices), and less heavily on other forms of credit than consumers in other states. Richard L.

card issuers will be to tighten their credit standards in an effort to issue credit to fewer and more credit-worthy cardholders. Those who cannot qualify for credit under the new standards may go to finance companies for larger purchases and attempt to arrange direct retail loans for smaller purchases. Even where loans are unavailable for kinds of purchases currently financed through credit cards (such as for meals, air transportation, and other travel expenses) credit may be effectively substituted by drawing larger loans for other purposes (such as auto loans, or second-mortgage credit lines at banks) and paying for a larger share of personal expenses in cash.

Studies of usury controls have devoted a great deal of attention to the possible distributive effects of interest rate controls, especially as between poorer and better-off consumers.[39] It is easy to imagine that these effects may be regressive, both in general and in the case of the national credit card proposals. Less affluent cardholders would probably be the first to be screened out by a restriction in credit card credit through application of tighter credit standards; if, lacking a bank line or a home eligible for a second mortgage, their next best alternative is a finance company personal loan, they are likely to pay considerably higher interest rates than they did when credit card credit was unregulated. The total redistributive effects of national rate ceiling would highly arbitrary and unpredictable. As a general proposition, however, individuals of modest means are likely to fair relatively better when the available credit is allocated by market prices than when it is allocated according to administrative judgments, credit records, and use of other financial services.

When consumers (of whatever income bracket) are deflected to other forms of borrowing, they will be worse off even when the explicit interest rate for the substitute credit is no higher, or is lower, than for credit card credit. Probably the most distinctive attribute of credit card credit is its convenience and link to cards' transactions features. Many consumers could reduce their total interest payments at present by drawing larger loans on cars or homes and carrying larger amounts of cash on hand; they do not because the small difference in cost is well worth the added convenience. So they would be worse off under credit card controls even if the total amount of credit they used remained unchanged and even if the amount of interest they paid declined.

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38. (Cont'd.) Peterson, "Effect of a Restrictive Usury Law on the Consumer Credit Market," Credit Research Center (1981). On the other hand, when Massachusetts dropped its usury ceiling selectively on small loans, the effect was a substantial drop in the small loans outstanding in the state. Robert W. Johnson and A. Charlene Sullivan, "Restrictive Effects of Rate Ceilings on Consumer Choice: The Massachusetts Experience," Working Paper No. 55, Credit Research Center (1980). Presumably this was because borrowers of small amounts lacked good substitutes (generally only finance companies among legitimate firms make small loans), or because they were able to increase marginally their debt on larger purchases.

39. See studies discussed in Vandenbrink, supra note 24.

A final effect of national rate controls would be increased segmentation of credit markets, both by type and by geography. Currently, credit card programs combine large and diverse pools of borrowers with different alternative borrowing opportunities -- and therefore compete with many different forms of consumer credit. Interest rate controls would reduce competition between types of credit because card issuers would tend to specialize in lower credit risks, leaving higher risks to a smaller set of remaining sources such as finance companies and smaller retailers. This effect has already been observed in some credit markets under state usury ceilings.[40] There is probably sufficient competion within credit categories (that is, between competing finance companies, between competing bank cards etc.,) that the effect of this segmentation on competition and interest rates levels would be small in the aggregate. In certain circumstances, however, the effect would be substantial: the wide availability of bank cards probably places a substantial constraint on the ability of smaller retailers to discriminate in rates among credit customers according to the intensity of their purchasing desires and their alternative borrowing opportunities.

Another type of segmentation would be more serious. The emergence of numerous national bank cards, especially following the wave of state usury deregulation in the early 1980s, has probably had a substantial effect in making credit markets more competitive, especially in smaller communities. If national interest rate controls had results similar to those already observed in states that maintain strict controls over bank card rates -- the withdrawal of card programs to exclusively state and local markets -- the benefits of this increased competition in the provision of consumer credit would be lost.

40. A. Charlene Sullivan, "Effects of Consumer Loan Rate Ceilings on Competition Between Banks and Finance Companies," Working Paper No. 38, Credit Research Center (1981).

DISCLOSURE REQUIREMENTS

Senator GORTON. Each of you has testified very eloquently against a legislated rate ceiling. None of you has commented at all on the second half of Senator D'Amato's bill on changes in the disclosure laws requiring more disclosure, either nationwide disclosure by a central agency like the Federal Reserve Board or required disclosure in connection with solitications.

I would like very briefly the comments of each of you on that point.

Do you have objections to increased requirements as to the disclosure of rates charged by credit card issuers?

Mr. RANCK. Mr. Chairman, on behalf of the NRMA, we said in our oral testimony that should the findings of this committee be that additional disclosure was warranted that we would not oppose it.

We are very concerned, however, that any additional disclosure requirements have additional costs. In the retail environment we lose money on credit. We would not like to have additional costs which would make that loss even greater.

However, we see no objection to advising the consumer, our consumers, what those rates are.

Senator GORTON. Thank you.

Mr. Anderson.

Mr. ANDERSON. I think we have two opinions on this.

One is, in general, with the industry becoming more and more deregulated, we are supporting deregulation in the industry. We hate to see any type of regulation move into that.

However, Rainier Bank and the Washington Bankers Association, I think I can respond, have always been prodisclosure of consumer information, and as a matter of fact, Rainier Bank has in the last 3 years sent out over 2 million solicitations for credit cards and in every case in the solicitation we included the interest rate.

Senator GORTON. Mr. Huddleston.

Mr. HUDDLESTON. Federal law requires full disclosure today. If we are referring today to the solicitation, I, as a banker from Indiana, have no problem with disclosing on the solicitation what your annual percentage rate is and what your annual fee or any other charges are.

I cannot represent the ABA on that. That is my own personal opinion.

As far as disclosing the rates through the Federal Reserve, I think that would be an operational nightmare. That is something that somebody else will have to determine and not myself.

Senator GORTON. On another subject, Mr. Ranck, the ABA suggests—you heard it at the end of his testimony—that one response would be steeper merchant discounts.

I think that you probably should have perked up at that. I suspect that would be a real concern to you.

Let's look at that in the real world. Do you have any evidence that your member merchants who use bank cards, accept bank cards are forced to accept higher merchant discounts from States with stringent interest rate ceilings—from the State of Washington, for example? Are those discounts higher in Washington?

Mr. RANCK. We, as an association, do not have hard evidence on that point. However, we do know the experience of our retailers across the country, and let me use the example of Arkansas.

The range in merchant discount rates for banks runs as low as 1 and as high as 6 percent, and it is our general conclusion, and the Arkansas experience supports that conclusion, that as the finance charge rate is reduced there is a corresponding increase in the merchant discount rate. In Arkansas we believe that it is close to 6 percent.

With me today is Mr. Dunkelberg, from Purdue University. He has done a great deal of research on that.

Senator GORTON. We would be happy to hear from him.

Professor DUNKELBERG. I can give you a few comments along those lines.

We did do a study a number of years ago of Washington State and California, since they were growing rapidly and were very near and had different rate structures at the time. Although I can't quote the numbers to you, I would like to supply the study.

COMPARISON BETWEEN CALIFORNIA AND STATE OF WASHINGTON

Roughly the merchant discount was twice as high in the State of Washington as it was in California, as were other kinds of fees and charges that the banks imposed on cards when compared to California.

So we saw a 12-percent finance charge rate in Washington State, with higher merchant discounts, higher late fees, higher penalties, et cetera, et cetera; where in California we saw a higher annual percentage rate but far lower merchant discounts and far lower fees for late payments.

Senator GORTON. Is that true today in Washington, Mr. Anderson? Is the merchant discount higher there?

Mr. ANDERSON. I think in general the merchant discount tends to be a little bit higher in the State of Washington. It is a question of what fees are higher in the State of Washington than they are in several other States.

Senator GORTON. How many Washington State banks issue credit cards?

Mr. ANDERSON. I can't give you an exact number of financial institutions. Probably the vast majority, over 90 percent of the cards are issued by the top 10 issuers within the State. That would include both banks, savings and loans, and credit unions.

Senator GORTON. Do they all charge the same rate?

Mr. ANDERSON. Yes, sir, with the possible exception of one who is exporting the rate from a different State but who also does business in that State.

Senator GORTON. Does Rainier make a profit on its credit card operations?

Mr. ANDERSON. Yes, sir.

Senator GORTON. You told me that you did market or you tried for a while to market outside the State, and you would regard a return of 9,000 as not having been a successful marketing technique?

Mr. ANDERSON. I think a rate of less than 3 percent on a direct marketing response rate to us is a very, very low response rate. In the State of Washington we get somewhere between 7 and 8 percent return on almost all of our direct solicitations.

Senator GORTON. Are you the only bank in Washington that attempts to market outside the State?

Mr. ANDERSON. No, I do not think we are, sir. I think the Seafirst Bank also markets outside the State.

Senator GORTON. Does it have the same relatively low success rate?

Mr. ANDERSON. The same relatively low success rate.

Senator GORTON. Are you saying then that interest rate competition, when you engage in it, is not particularly successful?

Mr. ANDERSON. It has not been successful to this point. That is exactly the point I was trying to make. Competing on the basis of interest rates does not catch the attention of the consumer.

I might add further that in early 1985 Consumer Reports made a publication, made a listing of the top credit cards in the United States. The No. 1 credit card was Rainier National Bank. We had less than 200 calls nationally to receive a card.

We would like to also submit some facts for the record on that issue.

[The following information was subsequently supplied for the record:]

CREDIT CARD SOLICITATION INFORMATION

STATE OF WASHINGTON

In 1984, Rainier National Bank solicited 274,875 Oregon households for credit cards emphasizing the interest rate differential and received 9,142 acceptances for an acceptance of 3.33 percent. During the same year we solicited over 450,000 Washington residents and had an acceptance ratio of 5.27 percent.

In February 1985, Consumer Reports listed the Rainier Visa card as the best card to hold in the United States. Including Washington residents, we received less than 2,000 applications as a result of this article.

Seattle First National Bank also solicited out-of-State cards and ran an in-State promotion offering a reward for out-of-State cards turned in with applications for SeaFirst cards. It is our understanding that their acceptance ratio, while somewhat better than ours, was less than similar solicitations within the State.

Senator GORTON. I remember that article. You got fewer than 200 calls?

Mr. ANDERSON. Fewer than 200 calls.

Senator GORTON. On the other hand, you have talked about the success of out-of-State banks in soliciting within the State of Washington, even though their interest rates are higher, but not all of those people—would they be a large percentage of those people who are poor credit risks, who have been turned down by Washington banks?

Mr. ANDERSON. No, sir, I think there's two things on the out-of-State ones.

And when I said we were making a profit, I will go back to that comment. We are making a profit, but there is a lot of credit needs we aren't fulfilling. Some of that is being fulfilled by out-of-State institutions.

The rest of it is the use of the higher income that those organizations can maintain to give add-on benefits. There are a number of

things which they provide free with a credit card, such things as airline insurance, credit card registration, the ability to have a discount on your purchases and use that money to purchase things from a catalog.

Those kind of add-on benefits are what bring even good credit risks out of the State of Washington, take the money from the State of Washington, and place it in another State.

Senator GORTON. Have you considered moving your operations out of State as a result?

Mr. ANDERSON. No, sir, we have not—at least recently—because we think our job is to provide credit for the State of Washington. In the past, we took a very serious look at moving our operations out of Washington State.

Senator GORTON. I recognize that there is some legal uncertainty about precisely what rate you can charge. In fact, I think the rate generally charged is higher than the nominal State ceiling because of the interaction between the most-favored-lender law and other laws.

If you could unambiguously raise your rates and you knew you were running no legal risks in doing so, would you raise your rates today, and would you relax your credit standards?

Mr. ANDERSON. Yes, sir. I think I can say that because we have looked at it very seriously within the last 2 years. We testified on that at the State legislature last year, that, No. 1, we would raise our rate but it was because we wanted to give the additional credit to the residents of the State of Washington and that would allow us to do that.

LACK OF COMPETITION

Senator GORTON. Mr. Huddleston, what is your view as to the reason for the lack of competition among major banks at least on credit card interest rates, at least until the recent drop of 2 points by Manufacturer's Hanover? Why has that been the case? Why has so much money gone into marketing and so little into competition on the basis of interest?

And maybe a further followup on that: Do you know whether Manufacturer's Hanover has been successful? Is it likely to have to be followed by other leading banks in New York?

Mr. HUDDLESTON. I cannot speak for Manufacturer's Hanover. I do not know if the number of applications have increased since they reduced their rate. I know the banks in New York have more of a risk problem than I do in Indiana. Their counterfeit and fraud losses are substantial.

But I am not sure that I believe there is not competition in the marketplace. I have a 15.6 rate. There are other banks that have lower rates. I think it is all in what your strategic objective is.

If the New York banks want to have 5 percent of the consumers in every major city in the United States, they are going to have a different risk.

I do not want to get out of the regional concept. I think it is all in what the bank's strategy is with the consumer because many of the credit cards that I have on the system today do not deal with Indiana National Bank and I am sure that Citicorp and Manufac-

turer's Hanover have many customers, more than I do, who do not deal with their bank except through the credit card. Their strategy is probably to offer other products and services down the road, and that affects how much risk they want to accept today.

Senator GORTON. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Ranck, we are trying to figure out who you look like. Somebody says the person who does these credit card ads on television. Staff says James Coburn. [Laughter.]

Senator GORTON. That is pretty good.

Senator D'AMATO. Let me ask you, on page 4 you said that among the principal reasons why you oppose this legislation or it should not be enacted are the following. One thing you say, we should ensure consumer awareness and reasonable access to the marketplace, not rate setting, as the proper role of Congress.

So then I go to Senator Gorton's statement with respect to disclosure, those aspects of the bill, the truth-in-lending provisions whereby disclosures would be made.

Do you have any objection to those?

Mr. RANCK. We do not take a position of objecting to disclosures. We do feel, however, that the consumer is well advised of the rates today and is sensitive to them. We are concerned about possible burdensome operational requirements and excessive costs which disclosure might impose on retailers. We are also concerned that rate disclosure only addresses one small facet of the overall cost of credit cards to the consumer.

Senator D'AMATO. So you are saying be careful, don't limit it simply to interest rates, but it should be the fee—and I agree with you—it should be when the interest is applicable, whether on the first day or the 25th or the 30th, but that kind of disclosure would be preferable than having just a partial disclosure?

Mr. RANCK. Senator D'Amato, I think that the convenience of the credit card means different things to different people, different things to different consumers.

For example, a balance on average carried in our Lord & Taylor department store in New York has a 19.8-percent finance charge rate. However, in my testimony I indicated that the average for retailers in general of revenue for that account was less than $20. Actually, it is much less than $20.

In fact, the finance charge revenue therefore is less than the annual fee, in a sense. If you look at the mix of products and services that are available from different creditors in retailing we also have some credit plans which are free credit plans.

Senator D'AMATO. We understand that. We are just talking about the basic principle of disclosure.

Mr. RANCK. It is very difficult to encompass all of these various features and benefits of various credit plans in some form of formal disclosure. We are very sensitive to that.

Senator D'AMATO. Mr. Anderson, you indicated that disclosure to the Fed would be a nightmare.

Mr. HUDDLESTON. I think that was me.

Senator D'AMATO. I am sorry, Mr. Huddleston. You said it would be a nightmare.

Now, your institution—I am not talking about the ABA now, but talking from your perspective of your bank in Indiana—wouldn't simply reporting what the current status of your interest rate charges were—would that be a nightmare—once a month?

Mr. HUDDLESTON. No, Senator, that isn't what I meant. I guess I would have to answer your question with another question.

I was trying to figure out how this disclosure would get to the consumer, how he would ever get it, how he would update it if you are changing your rates all the time.

GREATER AVAILABILITY OF INFORMATION

Senator D'AMATO. Yes; that is the big issue because I really believe that the consumers have absolutely no information or a relatively small pool of information with regard to the different rates and fees, et cetera, that are available.

If you want true competition, everyone says let the economic forces work, let the marketplace work by providing adequate information. What I am suggesting is that in order for the market forces and true price competition to work people have to have that information available to them to know where they can go for cheaper rates.

But the Fed would then be responsible for publishing it, and by the way, how many consumers would see the Federal report? I don't know. Maybe some of the news media would pick it up. Maybe some consumer groups would pick it up and carry that information out.

But certainly a lot more people would be informed as to the various rates, et cetera, that are available than are today.

But I was wondering what you meant by the nightmare.

Mr. Anderson, in your testimony you indicated that at Rainier over the last 3 years, that respectively you have rejected 59, 63, and 61 percent, respectively, of the applicants.

Well, supposing you were to charge 2 percent more, would those applicants have been more or less creditworthy? Would you have, because you are now charging 17 percent, taken an individual whom you deemed to be not creditworthy and then extended credit?

Mr. ANDERSON. I think that any time you deal with credit in the banking industry there is a balance between the profit margins you have and the creditworthiness of the individuals applying for credit. That is taken into consideration when you look at the creditworthiness of various individuals.

If we had the additional margins to operate with, yes, I think there would be a number of consumers whom we would have considered that we were willing to take the credit risk involved with them, and therefore by normal standards you would say they would have been judged creditworthy then because they would have received the card.

Senator D'AMATO. That opens up a whole other area. Mr. Huddleston related to that, also, in some of his testimony. It comes down to the fact and it goes right back to the point that Senator Hawkins made and I made.

It seems to me there are many people who are paying unusually high rates because institutions have made a judgment that they are going to take just about anything that walks and can sign an application.

I am not suggesting that it is your institution, and I may be overstating the case, and I admit that. But it opens up this area in terms of saying, my gosh, should people, for example, who have good credit ratings by any objective standards, given whether you are going to charge 15, or 16, or 17 percent, should they now have to pay a higher interest rate because you have deemed that as a result of your increased profit margin at that extra rate that you can now service others whom otherwise you would not?

And shouldn't you maybe be in the business of saying we will establish various rates, as we do for our commercial loans, for those people based upon their creditworthiness?

So in the case of—let's take the hypothetical case of Senators Gorton and D'Amato. You could say we could give him the 15 percent. You have to pay 20 percent.

Now, wouldn't that be fairer than just simply saying we are going to just expand the pool available, many of whom we otherwise wouldn't give credit to, because we can charge everybody 19.7?

Mr. ANDERSON. I think the argument might have some logic if we were talking in terms of normal kinds of consumer credit ala the installment loan, and that sort of thing. But when you talk about the credit card, you're no longer talking about purely a credit-granting system; you are talking about a payment system.

As the Senator mentioned early this morning, the credit card has become a means of identification. It has become—it goes beyond the just and normal balance of that argument.

Senator D'AMATO. Does Senator Gorton now have to pay 5 percent more because I've been granted a credit card that, under ordinary circumstances, you might not have granted?

Mr. ANDERSON. I don't think that's what I was saying.

Senator D'AMATO. What I'm trying to stress, and I wish Senator Proxmire was here to hear this, that you really testified to the point that you're pumping these cards out without much analysis of creditworthiness.

There are lots of people who shouldn't be getting solicitations and receiving cards that are. I commend you if you rejected 61 percent of the people; you must have figured that they couldn't pay back. They weren't creditworthy.

Mr. ANDERSON. We didn't know.

Senator D'AMATO. Oh, you didn't know. OK.

Mr. ANDERSON. There is a difference.

PROLIFERATION OF CREDIT CARDS

Senator D'AMATO. But I think we've hit one of the issues here. It may not make headlines but we're coming down to the point where I think it's rather important.

There are too many people who are paying an excessive interest rate simply because some of the institutions want to issue cards to everything that walks Mr. Chairman.

Senator GORTON. Thank you.

Mr. RANCK. Mr. Chairman, may I address Senator D'Amato's question as well?

From a retailer's standpoint, Touche Ross did a study in 1968 which examined the cost of credit. As you know, a measure of how many customers are accepted or rejected is really related to the amount that we charge off—the number of our mistakes.

In 1968, the chargeoff for retail creditors was 0.9 percent. A new study, which is not yet complete, indicates preliminarily that, in 1984, a comparable measure of chargeoffs for retailers was 1.13 percent, which is very little different.

So that, backing up to address Senator D'Amato's question, our credit grantors are not allowing customers to go off on a wild spending spree. With respect to retailers, our ratio between cash sales and credit sales in 1984 has changed little from our ratio of cash to credit sales in 1968; while there was a drop in 1980 under credit control, we have come back.

But, if you look over the long haul, over 20 years, it's about the same.

Senator GORTON. Thank you very much for your testimony.

I'm very sorry to report that we have just been informed that the space shuttle has exploded. All the people on board have been lost.

Mr. Fox and Mr. Holstein, we apologize. We will include your statements in the record and we will submit questions to you. At this point, the hearing is adjourned.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

[The complete prepared statements and questions of Mr. Fox and Mr. Holstein, and additional material for the record follow:]

STATEMENT ON

"CREDIT CARD INTEREST RATES"

BY

ALAN FOX
LEGISLATIVE REPRESENTATIVE
CONSUMER FEDERATION OF AMERICA

My name is Alan Fox. I am Legislative Representative for the Consumer Federation of America (CFA). CFA is the nation's largest consumer advocacy organization, with a membership of over 200 national, state and local consumer, rural, labor, cooperative, senior citizen and other groups that together have over 30 million individual members.

Four years ago, interest rates of all sorts reached record levels. The prime rate topped 20%. The discount rate reached 14%. Three-year Treasury Security constant maturities climbed over 16%.

Today, all of these rates have dropped substantially. The prime and discount rates are about half of what they were in 1981, 9.5% and 7.5%, respectively. Three-year Treasury Securities, cited by Federal Reserve Chairman Paul Volcker in a letter to Senator Dodd as "much more suitable as a possible index for consumer loans (than the discount rate)," are under 9.5%, more than a 40% decrease in four years.

Consumers have received some modest benefits from these sharp declines in interest rates. Fixed-rate mortgages, which in 1981 averaged over 15%, are now down to 12%. 24-month personal loans, once 19.2%, now average 15.6%. But credit card interest rates are today higher than they were in 1981. In August 1981, according to the Federal Reserve, credit card plans offered by a sample of commercial banks averaged 17.8%. In November 1985, those plans charged interest of 18.6%.

The Cost to Consumers

Last fall, Consumer Federation of America issued a report outlining this discrepancy in interest rates. The pattern of interest rate behavior is well-known. What is less well known is the impact of

these rates, in dollars and cents, on American consumers.

According to Federal Reserve statistics, revolving credit balances at commercial banks have more than doubled in just three years, from $34.1 billion in October 1982 to $73.8 billion in May 1985. Almost all of this amount reflects credit card purchases. Based on estimates that half of this credit is paid off immediately each month, we calculate that banks alone are collecting over $570 million dollars in interest on credit cards every month, or $6.85 billion a year, on top of annual bank card fees of $2 to $3 billion a year, and on top of fees charged to merchants who accept bank cards. A reduction in credit card interest rates just to the early 1980 level of 17.13% would save consumers over $500 million a year.

Consumers are Asking for Action

Credit card costs are thus of vital concern to American consumers. Consumers have waited patiently for credit card rates to decline to reflect these reductions in the cost of funds. Today, the consumers we hear from tell us their patience is wearing thin. The token responses of a few banks are insufficient; it should not be page one news when a bank cuts its credit card interest rates.

Bankcard Holders of America recently surveyed its membership on several issues relating to the cost of credit cards. BHA emphasizes annual fees as an issue; it is known as the best source for information on credit card plans without annual fees. But when BHA asked its members which of four issues they felt is the most important, 39% chose "Higher Interest Rates," while only 24% picked "Annual Fees," the next highest response.

We believe that consumers have waited long enough, and that their only recourse is to turn to Congress for action. We support whatever efforts are needed to bring credit card costs into line.

Why Rates are Too High

Interest rates on credit cards are too high. They are too high because they do not accurately reflect the costs of funds to banks, because there is insufficient true competition in the market, and because consumers are not provided with information they need to choose between competitors. The result is not only a market in which interest rates are too high, but one in which, taking all elements into account, consumers are unable to determine the true cost of the service they purchase.

Bankers recognize that the market works to their advantage and that high interest rates can thus be charged to consumers with impunity. They have few incentives to reduce the costs of providing services, because costs can so easily be passed on to consumers. In fact, some banks are taking advantage of high interest rates to market credit cards to less and less creditworthy customers. All consumers, not just these new customers, pay the costs of that marketing in higher interest rates.

The Cost of Funds

We have no disagreement with the industry statement that credit cards, as unsecured loans, must carry higher rates than secured loans to reflect their greater risk. But the cost of funds is an important element in the cost of extending credit through credit cards, as banks were quick to point out when underlying interest rates were high and

increasing. Credit card rates would, if the market were functioning properly, decline at least a modest amount to reflect dramatic decreases in the costs of funds over the past four years.

Bankers who now argue that the cost of funds is irrelevant would also have us ignore other changes in the cost of providing credit card services. Some of those other elements have or should have decreased in cost in the past four years. Greater automation and the spreading of costs to a growing base of card users should both act to cut costs.

The pricing of credit cards has been adjusted in many different ways to adjust to increases in the cost of funds. These pricing changes have involved factors other than interest rates, a fact often lost in the discussion. Annual fees, in particular, were widely introduced several years ago to compensate for banks' inability to raise interest rates to reflect increases in the cost of funds. As the cost of funds has decreased, annual fees have not come off.

Competition

The fact that rates have not come down is as good an indication as any that competition and the market are not functioning properly. We should not confuse the existence of a large number of providers of a service with the existence of competition. A large number of providers constitute a necessary, but not a sufficient, condition for a competitive market.

Competition is imperfect in all markets for consumer credit because of the disparity in information and market power between the offeror of credit and the consumer. The National Commission on Consumer Finance in 1972 stated that "the statistical evidence considered here indicates that competition cannot be relied upon at this point in time to establish rates at reasonably competitive levels in many states."

In testimony before this subcommittee in 1983, Manuel Johnson, the Assistant Secretary for Economic Policy, Department of Treasury, stated that:

> Consumer loan rates are generally considered to be administered rates. That is, they are posted by lenders rather than set by the market interaction of supply and demand conditions. . .(S. Hrg. 98-73, March 17, 1983, p. 19)

At a full Senate Banking Committee hearing a month later, Senator Proxmire asked Federal Reserve Board Governor J. Charles Partee to comment on that statement. Governor Partee replied:

> There is a degree of administration, no doubt, in the consumer lending area. As a Virginia resident, I have recently been receiving notices from the department stores that they will be raising their rates to 21.6 percent beginning in April. And there's no economic or marketplace justification whatsoever for that. It simply reflects an increase in the usury ceiling permitted in the State of Virginia.
>
> . . .I would say, though, that market competition is growing all the time in the major consumer lending markets. Hardly a week goes by but that I, and I'm sure you, don't receive offers of credit from other States <u>usually involving large amounts of money rather than low interest rates.</u> . . . (emphasis added) (S. Hrg. 98-111, April 12, 1983, p. 46)

Credit cards, as well as other forms of open-end credit, present some conditions which make competition even more difficult than for other forms of credit. Annual fees, which are now charged almost universally, serve to lock in consumers to a particular card for an entire year. The open-end nature of the agreement makes a calculation of the true costs of credit difficult; fees cannot be rolled into the interest charge for a single, accurate annual percentage rate figure. Perhaps most important, the cost of open-end credit cannot be reduced

to dollars and cents before an agreement is entered into as the costs of other credit contracts can. When all is said and done, the purchasers of a new home or a new car or a refrigerator compare figures for monthly payments more than they do APRs. But credit card plans by their nature cannot provide comparable information. In addition, most consumers are simply unaware of what market does exist. There is a general assumption, for example, that all Visa cards are identical.

These are not arguments to restrict the use or availability of credit cards, but they do point to reasons why the market functions differently, and less competitively, than for other forms of consumer credit. Public policy should take these conditions into account, and not simply rely on a market which does not exist.

All Consumers Pay for Risky Credit Extensions

Lack of meaningful competition has other implications for the costs of credit as well. We believe that banks have not responded aggressively to bank card fraud and have accepted accounts with higher probabilities of default because they can pass these costs on to consumers without risking loss of business. Restrictions on interest rates and other bank card costs may provide the incentive banks need to reduce both fraud and bad debts.

The connection between high interest rates and bank tolerance of fraud is well-documented. The December 2, 1985 Wall Street Journal describes several bank card programs awash in losses because they have pushed credit cards to consumers who were not creditworthy. But even the creditworthy consumers of those cards are forced to bear the increased fees and interest charges used to finance those expansion campaigns. As the article reported:

> Credit cards' steep fees and rates have kept that business profitable for most banks, in spite of surging charge-offs. And many big institutions are willing to absorb charge-card losses because the cards are seen as a way to build a nationwide customer base in anticipation of interstate banking a few years hence.

The Lexecon report prepared for the American Bankers Association, MasterCard, and Visa, entitled Interest Rate Controls on Credit Cards -- An Economic Analysis even goes so far as to argue that increased charge-offs are positive, because they indicate that higher interest rates lead to riskier credit extensions. Table 5 of the report (page 53) shows Visa charge-off rates in states with no interest rate controls to be over 50% higher than charge-offs in states with moderate or strict rate controls. "This indicates," the report says, "that unregulated bank card programs are much more likely to take business risks in order to supply cards to a greater number of consumers." It also indicates, as the report does not note, that creditworthy consumers are paying banks tens of millions of dollars to allow them to embark on these risks.

Disclosure Needed

Consumers simply do not know what they are paying for the use of their credit cards. A Mastercard study of 373 cardholders conducted in November 1984 reveals appalling statistics about consumer awareness:

- 27% of the consumers charged an annual fee are unaware they are paying such a fee. Of those who are aware of the fee, 35% knew the correct amount but 38% understated it.
- Only 25% of the consumers whose annual fee had been increased knew it; 67% incorrectly stated that there had been no increase.
- 78% of the consumers whose interest rate had been increased were unaware of that important fact.
- Only 17% of those surveyed knew their interest rate, 27% understated it, and more than half simply did not know.
- 70% of the consumers whose grace period had been eliminated in the previous three years were unaware of that fact. Of all the price components in the study, consumers were described as "least knowledgeable" about the elimination of grace periods.

Consumers do not receive clear information about credit card costs when they are asked to apply for credit cards. Current law provides for most disclosures only after the consumer has applied for and received a card. Disclosure requirements appear to be more suited to the days when credit card applicants more commonly applied for credit cards only at the bank at which they had other accounts.

Today, credit cards are marketed nationally by mail. These solicitations do include the amount of the annual fee and the interest rate, but these disclosures are rarely clear or conspicuous. They commonly appear in fine print on the back of the application, an application which is smothered in several pages of glossy four-color hype. Other important terms such as late fees and other charges and the method of calculation of balances on which interest may be paid are not disclosed.

As a result, applying for credit cards is a little like playing the lottery. Consumers do not find out what they need to make an informed choice until they have applied for and received the plastic card itself. Congress and the Federal Reserve Board should examine the Truth in Lending Act disclosure requirements with respect to open-end credit in light of this shift in credit card marketing and adopt requirements that all the conditions of credit cards be spelled out to a consumer in all promotional material which includes an application for credit.

Full Costs Cannot be Calculated: Balance Calculations

A variety of conditions, some due to the nature of open-end credit, some due to insufficient disclosures, contribute to consumers' inability to determine the true costs of credit card use. One important factor which has not been widely discussed is the impact of different balance calculation methods.

We all tend to think of credit costs purely in terms of interest rates. The assumption is that since 18% is less than 21%, a card with an 18% interest rate will cost less than one with a 21% rate.

A report prepared for the General Assembly of Virginia by the Colgate Darden Graduate School of Business Administration of the University of Virginia, entitled Credit Card Billing Practices in Virginia, illustrates the large effect balance calculation methods have on costs to consumers. The report notes that:

> Neither federal nor state statutes completely define the balance that is subject to finance charges. Consequently, a wide range of options for defining the finance charge balance is open to lenders and sellers.

The report goes on to calculate the costs consumers might bear under four balance methods permitted by Virginia law: Previous balance, average daily balance, ending balance, and adjusted balance. On accounts with identical patterns of activity -- a $400 previous balance, $300 payment, and $50 purchase at 18% during one month -- the finance charge ranged from $1.50 to $6 -- a factor of four.

The effect of these different balance calculation methods is far greater than the effect of even relatively large changes in the interest rate. An account using the most expensive method, the previous balance method, would have to have an interest reduced all the way down to 4.5% to result in finance charges as low as the least expensive alternative, the adjusted balance method, and the rate would have to drop to 11.25% to match the costs of even the second most

expensive alternative. Conversely, an account with an adjusted balance method could bear an interest rate of up to 72% before it would match the costs of the 18% previous balance method account.

Even banks using identical methods may produce vastly different results. The Virginia report describes in detail the "average daily balance" calculation of one bank which results in an "average daily balance" higher than the daily balance in any one day in the billing cycle. How does it arrive at this curious definition of average? The "average" is really the sum of the averages for the previous two months. In the example shown, a customer whose October cycle balance averaged $383.48 per day and whose November cycle balance averaged $426.52 per day was charged interest for November on the sum of those two figures, or $810.00, even though the balance never exceeded $685.30 on any day of the two-month period.

A careful consumer could select a card with a low interest rate, a reasonable annual fee, and a grace period, keep purchases to a reasonable level -- and still pay interest twice on the same amounts because a bank adopts a definition of "average daily balance" which defies logic and common sense, but not the law.

Recommendations

We believe that it is appropriate for Congress to establish federal standards for credit card pricing. Credit cards, more than any other form of consumer credit, are marketed across state lines by banks which take advantage of favorable conditions in some states to create an interstate market.

CFA has consistently argued against Federal preemption of state interest rate ceilings. We believe that the states have acted responsibly to balance the needs of creditors and consumers in the market for credit. Credit cards differ from other forms of consumer credit in that a national market has been established which allows offerors of bank cards to market those cards in a manner which restricts the States' ability to regulate the cost of credit within their borders.

The most expensive credit cards on the market today are those marketed nationally by banks working from a single state with unusually high or no interest rate ceilings. Congress could reduce credit card costs and place control of those costs at the appropriate level if it required banks to abide by interest rate ceilings in the state of residence of the consumer. Offerors of gasoline and other retail credit cards must abide by such limits currently.

If a national interest rate ceiling is established, Congress should be careful to ensure that other charges or conditions cannot be changed to thwart the intent of such a ceiling. There is probably little danger that annual fees can be increased substantially; consumers are very sensitive to annual fees because they can be so easily compared. But consumers would not be served if interest rates were reduced but grace periods for payment were removed. Restricting interest rates without restricting banks' ability to shift costs in this manner would not be seen as positive legislation by consumers.

For this reason, it may be fruitful to concentrate instead on improved disclosure. The Truth in Lending Act should require each solicitation for new accounts to include a standardized table showing fees, interest rates, and conditions under which fees or interest may be charged. The table should include all ways in which consumers might

have to pay for the use of a credit card, and fees not disclosed in the table should be prohibited. This information should be clearly and conspicuously disclosed with any material which includes an application for a credit card.

These disclosures will not be useful unless balance calculation methods are standardized. All the disclosures in the world will not allow a consume to compare costs when balance calculation methods are uncontrolled. The complexity of these different methods, and the many permutations designed by lenders, do not lead to further disclosure requirements as a solution. Credit card offerors should be required to use a carefully defined average daily balance method to calculate the balances against which finance charges may be imposed. Standardization of balance calculations, coupled with full disclosure of all fees and charges, will give consumers a chance to make the market work.

BANKCARD HOLDERS OF AMERICA
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A non-profit consumers association dedicated to protecting the interests of bank card holders

TESTIMONY OF ELGIE HOLSTEIN
ASSOCIATE DIRECTOR
BANKCARD HOLDERS OF AMERICA
BEFORE THE
SENATE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS
JANUARY 28, 1986

I am pleased to present testimony to the Committees today on behalf of the approximately 100,000 members of Bankcard Holders of America (BHA).

BHA is a national, non-profit consumer organization dedicated to educating the public on their rights and responsibilities as credit card users. BHA is the only consumer group working exclusively on credit card issues. Founded in 1980, BHA is completely independent, supported solely by membership dues and receives no corporate, government or foundation support. We are not a lobbying organization and have no connection with any bank, credit card company or financial institution. Our membership consists of individual consumers from every state.

We are submitting our comments because BHA believes that consumers are paying far too much interest on their credit card balances. Furthermore, we have come to the somewhat unfortunate conclusion that legislation is necessary because banks have been unwilling to adjust consumer rates to the real cost of money in the economy.

As a consumer education organization, we have always focused on what action the consumer can and should take in order to get the most out of the credit card marketplace; we believe that the most effective way to make the credit card industry sensitive to consumers' needs is to create a consumer constituency that is informed enough to shop for the best credit card account. What we have found, however, is a credit card industry that refuses to compete for customers on the basis of interest rates. Banks continue to argue that consumers are not sensitive to changes in credit card interest rates. The truth, however, is that because of inadequate information and a lack of real choice, consumers just don't know where to turn.

We are pleased to see that this Committee is considering solutions to this problem. My comments today will focus on the need to resort to a legislative remedy to protect consumers from unreasonably high interest rates on credit cards. I will conclude with some specifics on what we believe should be included in consumer protection legislation for credit card users.

After polling our members and looking at industry trends, we are convinced that there are five strong reasons why protections are needed in this area.

FIRST, CONSUMERS WANT CREDIT CARDS THAT OFFER LOWER INTEREST RATES AND THEY ARE WILLING TO SWITCH IN ORDER TO GET THEM

The banks have suggested that consumers will not choose to subscribe to cards that will save them money. Our members tell us differently.

We recently polled our 100,000 members in the "1985 Credit Card Users Survey". Three-thousand-five-hundred (3,500) members responded with specific information about their concerns as credit card users. We asked them "What do you feel is the most important issue facing credit card consumers?". High interest rates were rated number one on their list. We also asked if they would switch to another Visa or Mastercard if it offered a lower interest rate, and 66% -- two out of three -- said yes. Seventy-nine percent of these card users reported paying 18% or more on their credit card balances and 69% said they carry over some balance on their card--with 38% maintaining a monthly balance of over $500.

Credit cards are no longer a luxury for the rich. They are a necessity for the millions of consumers who have grown to depend on them as an alternative payment mechanism. Seventy percent of all consumers have at least one credit card. We challenge the credit card industry to start providing credit cards that reflect more equitable interest rates for consumers and more reasonable profit margins for banks.

SECOND, EVEN THE MOST INFORMED CONSUMERS FIND THEMSELVES WITH FEW CHOICES IN THE CREDIT CARD MARKETPLACE.

Much of our educational effort is designed to inform consumers about what a credit card actually is. A credit card is a personal loan that you access with a piece of plastic. As with any loan, it is important to shop around to make sure you are getting the best rate on the money you are borrowing. Few of us accept the first car loan or mortgage offer we can find. Wise consumers research loan rates first and then apply for the loan that best fits their needs. The same should be true with credit cards. Consumers need to shop in order to get the best rates.

However, as we communicate this message to consumers with pamphlets on such topics as "How To Shop For A Bank Card" and our "No Annual Fee List", we receive responses like the following:

"...I know I am supposed to look around for the best interest rate, but where do those deals exist? I certainly can't find them in my area..." or "...I am receiving all sorts of offers on credit cards but I can't seem to figure out how to get an offer for a card with decent rates...do you know where I can find one?"

The banks are clearly benefitting from the fact that many consumers are

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GORTON FROM ALAN FOX

Question 1. You acknowledge that there are a large number of issuers, but argue that this is insufficient to guarantee competition, partly because of disparity in market power between the consumer and the card issuer. What do you mean by market power? Do you think that high cost card issuers have any ability to coerce consumers into accepting their cards?

Answer. The disparity in market power stems from two sources. First, card issuers' terms, prices and conditions are nonnegotiable. Consumers are unable to bargain with a particular card issuer for more favorable terms. If information about competitors' terms were readily available, this would not be as serious a problem, but in fact little information allowing consumers to evaluate options is provided prior to the consumer's commitment to apply for and accept a particular card.

Second, the terms and conditions of a card are well understood by card issuers but are generally not understandable by consumers. Factors such as balance calculation methods are carefully developed by card offerers, but are rarely presented to consumers in ways which allow meaningful evaluation.

The result is that in order to receive a credit card a consumer must agree, at the time of application, to terms, conditions and prices which are not negotiable; many of which will not have been disclosed; and the implications of which the consumer will not be able to adequately evaluate even upon disclosure. Since these conditions exist with respect to every single offerer of the service in the market, specific issuers of high cost cards need not be able to "coerce" consumers into accepting their cards. They simply have as good a chance as lower cost offerers of attracting consumers because consumers are unable to determine which is which and are unable to bargain for more advantageous terms.

Question 2. You say in your testimony (p. 6) "* * * most consumers are simply unaware of [market choices] * * *" I understand, however, that the Federal Reserve has published studies suggesting the opposite. Are you aware of these studies, and do you have any comment on them?

Answer. I am aware of only one study on the subject, the 1977 Consumer Credit Survey. As far as I can determine, that survey only asked consumers what the APR was on their credit cards, and found that a large number knew their APR.

I have the following comments on that survey:

(1) I do not believe any attempt was made to verify whether the APR cited was correct. The Mastercard survey, cited on page 7 of my testimony, indicates that over half of the consumers who were able to cite an interest rate understated the rate, and that most were not even able to cite a rate. While that survey suffers somewhat from a small sample size, it does raise the point that verification of consumers' citations is necessary to draw any conclusions about consumer awareness.

(2) In 1977, the credit card market was far simpler than it is today. State cellings on interest rates were generally in force, and had not changed for some time. As late as 1979, no State had eliminated interest rate ceilings, and half the States had 18 percent ceilings. Furthermore, bank card offerers had not begun to market cards nationally from a bank in a single State, a practice which allowed for the first time varying interest rates in the same State.

(3) Even if consumers are aware of the rate they pay on their own card, they may not know that there are alternatives available at other rates. Many sophisticated consumers with whom I have spoken were not aware, for example, that individual banks set Visa and Mastercard rates; they assumed that all Visa and Mastercard rates were identical.

(4) Consumers must be able to evaluate factors other than the interest rate to be fully aware of market choices. Indeed, for "convenience" users the interest rate is irrelevant and grace periods and annual fees are important. Again, the Mastercard study cited on page 7 of my testimony reveals that few consumers are aware of these factors. Fewer still would probably be aware of the terms of cards other their own.

Question 3. Mr. Anderson pointed out that Rainier Bank, with lower interest rates, has much higher credit card application rejection rates than most other banks. No doubt these tougher standards reject some good credit risks as well as some bad ones. Is this in consumers' interests? Does CFA endorse tighter credit standards on credit cards?

Answer. We do not know what banks' "standards" for credit card issuance are, so it is difficult to comment on whether they should be tighter. No doubt these standards very widely from bank to bank and may be linked to factors other than or in addition to interest rates.

Clearly, higher interest rates encourage banks to take risks which are not in the interests of those of their customers who are good credit risks. An article in the December 2, 1985 Wall Street Journal cites some of these unreasonable risks: Cards sent to inmates in a State prison and to an 18-year-old recent high school graduate with no job.

Consumers who are good credit risks pay for reckless marketing of credit cards in two ways: Banks increase fees and interest rates to cover increased losses, and they pay when portfolios become so burdened with debt that regulators must step in and straighten out the resulting problems.

If rates are reduced, some good or borderline credit risks may be denied cards by some offerers. There is no reason to believe, however, that every bank uses the same criteria. Therefore, good credit risks should be able to find offerers willing to extend credit even if all offerers will not. Some banks now offer secured credit cards to consumers who are borderline or unknown risks. These cards, which require the maintenance of a savings account at the institution offering the card as security, are a far more attractive answer to the problem than higher rates for all consumers.

Question 4. You make a quite interesting point when you show that subtle differences in balance calculation methods can swamp even large interest rate differentials in terms of the cost to consumers. What does that lead you to conclude about the two bills at hand today? Also, you address this obliquely in your statement, but let me ask you directly: Should the Federal Government regulate balance calculation methods?

Answer. Legislation which deals with some aspects of credit card pricing without dealing with others will not serve the interests of consumers. In particular, strict interest rate limits will probably lead to the reduction or elimination of grace periods and to more ingenious ways of increasing the balance on which interest is paid. This will increase the cost of credit cards for many consumers, in particular those who most frequently pay off their balances. It will also increase confusion about credit card pricing because it will increase the emphasis on exactly those factors about which consumers know the least.

Interest rates, late fees, annual fees, and the existence or absence of grace periods are relatively easy to disclose and to compare. If all other factors are held equal, most consumers would be able to use those pieces of information to decide which credit card best meets their needs. Unfortunately, all other factors are not equal. In contrast to the other factors, the balance calculation method does not lend itself to easy disclosure in a form understandable by consumers and suitable for comparison between different cards.

I have enclosed an exhibit from the study Credit Card Billing Practices in Virginia, prepared by Charlotte H. Scott of the University of Virginia pursuant to a resolution of that State's senate. All three banks whose disclosures are contained in the exhibit use methods which they call "Average Daily Balance." Yet, as the exhibit goes on to show, the balances actually arrived at for the November billing period are $810.00, $437.96, and $424.03. I doubt that any consumer could read the disclosures and easily determine that the results would vary in this manner, yet the difference between an $810 balance and a $424 balance is far more important than any of the cost factors which can be easily disclosed.

If the Federal Government requires a single standardized balance calculation method and required disclosure of all other factors, consumers will be able to accurately compare the full costs of credit cards. I see no other way to make the disclosures meaningful and to thus allow the market to function efficiently.

Question 5. Should legislation—be it these bills today, or some other bills on the same topic—be applied to retail cards as well as to bank cards?

Answer. There are fundamental differences between retail cards and bank cards. Those differences have been spelled out by offerers of retail cards, and are reflected largely in differences in pricing.

While the States are not able to control the costs of banks cards offered within their borders, they are able to control the costs of retail cards. As we have pointed out, this means that a better case can be made for Federal regulation of bank card pricing than for Federal regulation of retail card pricing.

Disclosure legislation need not and should not be limited to bank cards. Regardless of the type of card or the use to which it will be put, consumers deserve accurate information about all card costs before they apply for a card. The disclosures I have urged are so simple and concise that I cannot imagine they would entail any significant compliance costs for either bank card issuers or retail card issuers.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GORTON
FROM ELGIE HOLSTEIN

Q. 1. You report a survey of you members in which 66% say they would switch credit cards for lower rates. Yet, in my state, the low-rate Rainier Bank is losing market share. Isn't there a disparity between what consumers say they will do, and what they in fact do? Suppose that, in a world of clear disclosure and choice, consumers still don't display interest rate sensitivity. Should Congress still try to regulate this market?

A. 1. You ask whether Congress should "still try to regulate this market" if consumers do not seek actively low-rate cards. The first problem is that consumers have no basis for comparison among cards, since most credit card advertising contains no reference to the terms and conditions of the cards. In the case of many card offers, consumers do not learn of the interest rate and other charges until they actually receive the card. Then, if they fail to cancel it within 30 days they are immediately subject to annual fees, even if they do not use the card.

The banking industry is fond of citing the loss of market share by banks issuing credit cards in states, like your own, which require interest rates lower than the current national average of 18.5%. Their preposterous assertion is that consumers actually prefer paying higher interest rates. By this reasoning, if interest rates were lowered through federal legislation, consumers would stop using their cards altogether in protest against the lower rates!

The facts are that large banks located outside Washington State have been aggressively marketing cards into the state with higher interest charges. The absence of clear disclosure requirements, combined with a number of consumer misconceptions about credit cards, have resulted in consumers accepting large numbers of those out-of-state cards. The consumer misconceptions to which I refer include the belief that all cards carry the same rates (an understandable view), or that a card from a large money-center bank is more widely accepted than one from a smaller local bank. Of course, the vast majority of consumers live in areas without access to low-rate cards, so they have no real choice at all.

Finally, I do not believe Congress should wait until consumers chain themselves to the front doors of banks before taking action. I believe that, as in the case of the check-hold legislation recently passed by the House, consumers have a right to be protected from abusive banking practices, even if many are unaware that they are being victimized. Indeed, as we learned in 1929, the financial health of our nation requires that consumers have faith in the integrity of our financial institutions and in the oversight by their government of the activities of those institutions.

Q. 2. You also say that credit cards are not a luxury, but a necessity. A great convenience I would agree. But a necessity? I question whether we aren't rendering that term a little meaningless. Do you believe that the federal government should guarantee the availability of low cost credit cards, on the grounds that they are a necessity of life?

A. 2. You suggested that a credit card should be viewed as a "great convenience," not, as we suggested in our testimony, a necessity. To the extent that credit cards have become both a form of identification required for such purposes as check-cashing and an exclusive payment form required for transactions such as automobile rentals, they have become for many people, in fact, a necessity.

We would not, however, disagree with you that calling credit cards a necessity for everyone is an overstatement. Ironically, it is the banks that seem most inclined to make that overstatement, when they argue against this legislation by displaying an uncharacteristic concern for the credit needs of low-income people.

There is no doubt that lowering credit card interest rates would require somewhat greater scrutiny of credit card applications than now exists (see attached Wall Street Journal article), much as the banks now exercise such scrutiny with other personal loans. As Senator D'Amato has suggested, however, the vast majority of the nation's 160 million bank card holders are currently subsidizing the extension of credit through indiscriminate mass-marketing campaigns to many individuals who may not be creditworthy.

In any case, we do not believe that this legislation would significantly impair access by lower-income people to credit. For example, home equity loans and personal loans would still be available to them, often at interest rates far below current credit card rates. Even those at the lowest end of the economic scale could still have the convenience of a credit card by obtaining "collaterized" cards, which are tied to a deposit account balance.

In direct response to your question, I do not believe that the federal government should "guarantee the availability" of low-interest rate credit cards because they are a necessity. I do believe that Congress should protect consumers from usurious credit card interest rates when, as now, every other interest rate in the economy has fallen by as much as 50%. By using a variable rate in the legislation, the banks, in turn, would be protected from losses when their costs rise.

Q. 3. Recently both the Seattle Times and the New York Times have run articles urging consumers to shop for the bargains that exist in the credit card market. How do you recommend to your members that they go about this?

A. 3. When it comes to credit cards, the admonition to consumers to "shop around" becomes very nearly laughable. Any consumer that turns in his or her bank card because the interest rate is too high, stands little chance of getting a better rate down the street. Our members are provided lists of the handful of banks that charge low interest rates and no annual fee. Since these banks are so few and far between, the majority of Americans simply do not know where to look for low-rate cards, and thus have no real choice at all. In fact, the top twenty-five card-issuing banks, which are engaged in the aggressive national

marketing campaigns, are charging an average interest rate of 19.4%--above the 18.5% national average -- in spite of the fact that they enjoy the greatest economies of scale in their credit card operations.

Q. **4. You state that "Credit overextension has become a significant problem for our economy." Would you still endorse these bills if you believe that, say, 5 million customers would have their cards revoked if they went into effect?**

A. 4. We cannot imagine that legislation lowering credit card interest rates would cause the revocation of five million cards. As discussed in question 2, above, it might well encourage greater scrutiny by the banks of new card applications, but large-scale revocation of cards is highly unlikely for three reasons.

First, the card issuers will be reluctant to lose the revenue from the interest rate, annual fees, merchant fees, late fees, over-the-limit fees, transaction fees, etc.

Second, they will want to retain their cardholders as a base of potential clients for the rapidly growing array of <u>other</u> financial products and services they are marketing. (The declining relative importance of credit card revenues as a measurement of large financial institutions' return on investment in card operations is a further weakness in the banks' argument that high rates are needed to cover costs.)

Third, revocations would not be expected to take place at all in the cases of those with good payment histories, <u>regardless of income.</u> In the cases of cardholders whose payment histories already suggested they were a poor credit risk, the effect of this legislation might well be the <u>retention</u> of larger numbers of cardholder accounts than would otherwise have been possible.

Q. **5. If we regulate credit card interest rates, would you anticipate that credit card companies would increase their merchant discounts? If so, isn't this especially unfair to consumers because if falls on both cash and credit customers?**

A. 5. The question of whether or not card issuers would attempt to recover the loss of excess profits through imposing higher discount fees on merchants or through other consumer charges represents a valid concern. Merchants, however, are in a much stronger bargaining position than are individual consumers, so I believe that increases in the merchant discount fees are unlikely. The imposition or increase of other consumer charges could be minimized by including in the legislation strong disclosure requirements for credit card advertising, which, as noted earlier, now usually contains no mention of the terms and conditions of the cards. Consideration should perhaps be given as well to the inclusion of uniform accounting procedures for credit card operations. Such provisions, in our view, would be reasonable first steps toward restoring competition and information to the credit card marketplace.

Thank you for the opportunity to respond to some of your concerns about the proposed credit card legislation. We look forward to continuing to work with you and your colleagues on these important issues.

Sincerely,

Elgie Holstein

Elgie Holstein
Associate Director

Wall St Journal
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Loan Morass

Losses on Credit Cards, Other Consumer Debt Are Climbing Rapidly

Banks and S&Ls Mail Plastic To People Who Spend, Can't Pay and Go Broke

'Too Much of a Good Thing'

By Charles F. McCoy
Staff Reporter of The Wall Street Journal

About 18 months ago, Home Federal Savings & Loan Association of San Diego began an ambitious expansion of its credit-card operation to cash in on the fat fees and lucrative rates that that business can bring. "We wanted more of it," says William Mayer, Home Federal's senior vice president for accounting. "We thought it would be a stroll in the park."

The stroll in the park has ended with a mugging. Home Federal mailed offers of pre-approved charge cards with credit lines of as much as $5,000 to people who had no jobs, who were dead or who were just plain deadbeats. Last month, Home Federal decided to abandon the credit-card business by selling it; the S&L said it faces losses of $30 million or more. About half the losses were blamed on people who snapped up Home Federal's easy plastic, ran up huge bills and headed straight for bankruptcy court.

"We managed to find an unbelievable number of consumers who wound up broke," Mr. Mayer says. "We got blindsided."

Wide-Ranging Effects

A lot of other financial institutions face similar trouble. After three years of wild growth, consumer debt is fast becoming another sinkhole in lenders' credit swamp. Beyond the jolt that threatens for an already-shaky banking industry, a growing number of economists cite such evidence as October's record monthly drop in retail sales as signals that a deterioration in consumer debt has spilled over into the general economy, menacing the recovery and possibly presaging another recession.

"The consumer has been the guts of this economic expansion," says Edward Yardeni, the chief economist at Prudential-Bache Securities Inc. "If he is so soaked with debt that spending slows, that's it—the expansion is finished. Consumer debt is a problem for a lot more than bankers."

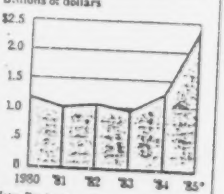
Over the past three years, lenders chasing rich returns and consumers chasing the good life have pumped up consumer installment debt to a record $524.3 billion, a 57% surge from $335 billion at the end of 1982, according to the Federal Reserve Board. In September alone, consumer debt jumped $10.6 billion, another record, partly because of a surge in auto sales.

Many Disasters

But often credit has been given where credit isn't due. Bankers have climbed further and further down the economic ladder in the frenzied search for new customers. Prisoners, unemployed teen-agers, even a few nonexistent pets have received credit cards.

Mary Ceballos, a San Diego secretary whose salary is $16,100 a year, says she was "mildly surprised" when Home Federal sent her a MasterCard with a $5,000 line of credit earlier this year. She was more surprised when, within a matter of weeks, Home Federal sent her two more. Mrs. Ceballos says she owed the thrift more than $9,000 when she recently filed for personal bankruptcy.

Consumer Loan Losses
Billions of dollars



Note: For banks with at least $300 million in assets
*Estimate
Source: Based on FDIC data

Such episodes are becoming more and more common. In the first half of 1985, consumer loan losses just at banks with more than $300 million of assets surged to almost $1 billion, nearly double the year-earlier level. Losses at smaller banks were up by one-third to $211 million.

Delinquencies High

Much heavier losses loom. Almost all types of consumer debt are going bad at near-record rates. About $2 billion of debt run up on bank-issued credit cards such as Visa and MasterCard is delinquent, based on data compiled by the American Bankers Association. Some 3.5% of all personal loans—loans on cars, second mortgages and the like—are past due, more than at almost any other time in the past five years. Mortgage-loan delinquencies are still hovering close to the all-time peak hit earlier this year. All told, roughly $48 billion of the $2.6 trillion of consumer and mortgage debt is past due.

"A lot of those loans might as well have been made to Poland," laments Gary Burton, the vice president of credit-card operations at Liberty National Bank & Trust Co., a big card issuer based in Oklahoma City. "Our industry has flat overdone it."

However, losses on consumer debt are

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Loan Morass: Losses Are Soaring On Credit Cards and Other Debt

Continued From First Page

widely dispersed throughout the banking system. That suggests that they aren't concentrated enough to cripple scores of institutions, as farm and energy loans have done. Credit cards sleep less and rates have kept that business profitable for most banks, in spite of surging charge-offs. And many big institutions are willing to absorb charge-card losses because the cards are seen as a way to build a nationwide customer base in anticipation of interstate banking a few years hence.

Nonetheless, bad consumer debt is gnawing at some of banking's biggest names. Citicorp, the largest bank-card issuer with some 31 million charge-card accounts, wrote off $492 million of consumer debt this year through Sept. 30, more than double the year-earlier amount. John Reed, the chairman and chief executive, concedes that consumer losses have grown faster than the bank anticipated, and he predicts higher charge-offs next year.

First Chicago Corp., which has expanded its credit-card business 30% to three million cards outstanding in the past two years, has seen its consumer losses in the nine months climb to $64.6 million from $25 million. George Salem, banking-securities analyst at Donaldson, Lufkin & Jenrette, says First Chicago's credit-card losses are running about twice the normal percentage level.

Keefe, Bruyette & Woods Inc., a bank-securities firm, recently cut its 1985 earnings projection for First Atlanta Corp. to $2.25 a share from $2.40; it cited "unexpectedly high continuing" losses in the bank's $930 million credit-card portfolio. And beleaguered BankAmerica Corp., whose nine-month consumer-loan losses surged 64% to $189 million, concedes that losses on its more than five million credit-card accounts are running 10% higher than expected.

Ironically, bankers have stampeded into consumer lending partly in search of a profitable refuge from the loan disasters in commercial-banking mainstays such as the steel, shipping and energy industries. But, "we all charged at the consumer at once," says Allen Sanborn, executive vice president at BankAmerica. "When you push a market that hard, there has to be some deterioration." Indeed, the ratio of losses on consumer loans to losses on commercial loans, 1 to 5 last year, has narrowed to 1 to 2. "There's certainly some danger in this that not everyone saw several years ago," Mr. Sanborn adds.

Both the perils and the allure of consumer debt show up most in banks' credit-card operations. They have been the arena of some of the most explosive growth: Banks and thrifts had about $68.1 billion in credit-card debt outstanding as of July 31, up 88% since 1982.

The primary attractions for bankers are interest rates that are averaging about 19.4%—10 percentage points above the prime, the basic lending rate to businesses—and annual fees that can range as high as $25 a card. But cards also appeal to the new breed of banking technocrat. By using elaborate statistical models and computer runs, some bankers contend that they can weed out bad credit risks, limit defaults and predict losses accurately.

"It's a business where you can really limit surprises," Ira Rimmerman, the head of Citicorp's international consumer operations, said in an interview earlier this year. "It is almost actuarial in nature."

Changes Ignored

That clearly hasn't proved true, and some bankers now suggest that credit-card operators have abstracted themselves into a morass. "These people with their models are very sharp, but they can lose sight of one thing: At some point, the condition of consumers changes, and the models become so removed from reality that they're meaningless," says John Rau, the president of Exchange National Bank in Chicago.

Credit-card underwriting often does seem something short of scientific. Institutions usually find credit-card customers by simply mailing out thousands of applications or offers of pre-approved cards. They often cull prospects from subscription lists of upscale magazines: Home Federal, for example, targeted Forbes subscribers during much of its ill-fated credit-card expansion. Generally, credit bureaus are hired to trace each prospect's credit history.

But such mail-order credit reviews frequently don't turn up elemental information. A former credit officer at Bank of New Orleans recalls sending credit cards to a batch of consumers who the bank's computers showed had steady jobs and noteworthy records. True enough: They were inmates at Angola State Prison, 155 miles northwest of New Orleans.

Other Strange Cases

Other practices seem equally dubious. Early this year, Citicorp sent a $1,500 credit card to an 18-year-old girl just graduated from high school. She had no job and no savings account, but she soon had a car—leased on her Citicorp card. In another case, Kathy Buckner, a 22-year-old Houston computer technician, received a Diner's Club credit card from Citicorp and a MasterCard from First City Bancorp. in Houston about two years ago. Her take-home pay at the time: $12,000. She now owes about $11,000, some $5,000 on credit cards. "It'll take me years to get debt-free," Miss Buckner says.

So many institutions have been shoving plastic at consumers these days that it has become almost impossible for lenders to gauge how many cards their prospects have.

"Your credit review may show that on such-and-such date, this person had one credit card and a good record, so you send him a card," Home Federal's Mr. Mayer says. "What you don't know is that at the same time you were sending him a card, so were Bank of America, Citicorp, Security Pacific. Pretty soon, that person who looked like a good credit risk has enormous potential for getting in trouble."

Richard Adolphson's case seems a classic. A 59-year-old security guard at an ammunition plant in Burlington, Iowa, he earns about $22,000 a year and had always paid his few debts promptly. When banks all over the country began stuffing his mailbox with offers of pre-approved plastic, he happily signed on.

But when he filed for bankruptcy last year, he owed $35,250.51, mostly on his 31 credit cards, and his interest costs alone were running nearly $6,000 a year. He had at least six cards from First National Bank of Omaha, Neb., one of the biggest credit-card issuers in the Midwest. First Chicago, Chemical Bank, Michigan National Bank and half a dozen others also gave him cards, all in a matter of months. "They kept sending me cards, so I figured I must have been OK," he says. "Either that or they were awfully lax."

Now, a few banks, getting nervous, have begun to curtail credit-card promotions. Some bankers also worry that Congress, pressured by consumer groups, may move to limit the rates that banks can charge on credit cards—cutting into profits.

Mostly, though, lenders continue to shovel credit out to consumers. Sears, Roebuck & Co. is hawking its new Discover credit card; it hopes ultimately to issue some 10 million. RepublicBank Corp., the biggest bank in Texas, has just launched a major credit-card push after long shying away from expanding the business. Thrifts, which did little consumer lending before 1981 but now hold some $40 billion in consumer debt, are barreling into credit cards; First Federal Savings & Loan Association in Detroit, for example, began issuing cards last summer. Great Western Savings in Beverly Hills, Calif., ballooned its credit-card loans to $2.6 billion at Sept. 30 from $65 million at the end of 1983.

All that activity is viewed with bemusement by Home Federal's Mr. Mayer. "We found out that credit cards are like everything else in banking," he says. "It starts out a good thing, but pretty soon everybody's diving into it. And then, it's too much of a good thing."

Melville's Sales Increase 7.8%

HARRISON, N.Y.—Melville Corp. said its retail sales from continuing operations for the four weeks ended last Saturday increased 7.8% to $410.9 million from $381.1 million a year earlier.

UNIVERSITY OF VIRGINIA THE COLGATE DARDEN GRADUATE SCHOOL OF BUSINESS ADMINISTRATION

TAYLOE MURPHY INSTITUTE

October 18, 1985

TO: Committee on Commerce and Labor,
Senate of Virginia, and
The General Assembly of Virginia

During the 1985 General Assembly the Senate passed Senate Resolution No. 34, which requested that the Tayloe Murphy Institute of the University of Virginia study credit card procedures. The Tayloe Murphy Institute was requested to report its findings to the 1986 General Assembly; and herewith submits its report entitled Credit Card Billing Practices in Virginia.

Respectfully submitted,

James C. Dunstan
Director of Tayloe Murphy Institute

Charlotte H. Scott
Senior Fellow of the Institute and
University Professor of Commerce
and Business Administration

Exhibit C.1

Disclosure Statements of Three Banks

for Calculating Their Finance Charge Balances

Credit Card of a Virginia Bank: Bank A

Finance Charge Calculation: We figure the finance charge on your account by multiplying your "average daily balances" for credit purchases and advances by the appropriate periodic rates. This is how to calculate your "average daily balances."

A. For Credit Purchases:

Step 1: If you paid the Previous Balance shown on the front of this statement in full by the due date that appeared on your last statement, your "average daily balance of credit purchases" is zero. Otherwise, go to Step 2.

Step 2: Start with the Previous Balance shown on this statement. Subtract from this amount any finance charges, late charges, and advances that it includes. You may need to review one or more of your prior statements to determine how much to subtract. This gives you your "Old Credit Purchase Balance."

Step 3: Go through the billing cycle shown on this statement one day at a time. For each day, take your "Old Credit Purchase Balance" and subtract any payments or credits that apply towards credit purchases and that have posted since the beginning of the cycle. (Remember that your payments and credits apply first to finance and late charges, then to billed advances, and then to billed credit purchases.) This gives you a daily balance for each day.

Step 4: Add all the daily balances obtained in Step 3 and divide the sum by the number of days in the billing cycle. Save this figure for use in Step 7.

Step 5: Now get your last statement and go through that billing cycle one day at a time. For each day, start with a zero balance and add any credit purchases that posted since the beginning of that cycle. This gives you a daily balance for each day.

Step 6: Add all the daily balances obtained in Step 5 and divide the sum by the number of days in the billing cycle shown on your last statement. Save this figure for Step 7.

Step 7: Add the figures you obtained in Steps 4 and 6. The sum is your "average daily balance of credit purchases."

B. For Advances:

Step 1: Start with the Previous Balance shown on this statement. Subtract from this amount any finance charges, late charges, and credit purchases that it includes. (Your annual membership fee is considered a credit purchase.) You may need to review one or more of your prior statements to determine how much to subtract. This gives you your "Old

unaware that different banks can charge different rates for the same type of card. Yet even those informed consumers who are aware of the possibility of lower interest rates must look far and wide -- often beyond their state's borders -- to find a fair rate.

We are pleased to note that recently there have been a few weak signs of responsible credit card pricing policy among a handful of banks. This is an encouraging sign, but rates are still far too high, nationally averaging 18.6%.

THIRD, BANKS HAVE SHOWN US THAT THEY WILL NOT BE RESPONSIVE TO CHANGES IN THE ECONOMY ON A VOLUNTARY BASIS.

In the last four years, three major economic indices (discount, prime and three-month treasury bill rates) have all fallen by 50%. With them, the banks' cost of money has also fallen, yet interest rates on credit cards have actually increased: from 17.8% up to 18.6%. In response to the drop in the cost of funds, interest rates on auto loans, mortgages and commercial loans have all declined. Why haven't credit card loans followed suit? Obviously, because they haven't had to. Instead, the banks compete by offering book-of-the-month club memberships, travel insurance, rebates, credit card protection, and other so-called "benefits".

In addition, interest rates are just one way in which banks make money on credit cards. There are annual fees (which vary between $15 and $25 for a standard card), there is the merchant discount fee (which ranges between 1% to 5% on each purchase made), and in many cases there are transaction fees, service fees, late fees and, increasingly, accrual of interest from the date of posting. Finally, initial credit limits range between $500 and $2,000 per card, (a relatively small loan amount by bank standards) but because of the economies of scale involved, credit card "loans" are much cheaper to administer than small, individual consumer loans.

FOURTH, THERE ARE BANKS CURRENTLY MAKING PROFITS AT INTEREST RATES FAR LOWER THAN THE NATIONAL AVERAGE OF 18.62%

Arkansas, where state law keeps credit card interest rates at five points over the discount rate, is a case in point. Banks located there, such as Union National Bank and Simmons First National Bank, that are currently charging 12.5% on their credit cards and admit to making a fair profit.

Washington State has interest rates averaging 15%. Ranier National Bank in Seattle is one bank which charges 15%. Chevy Chase Savings and Loan in Maryland now offers a variable rate credit card currently at 14%, with no annual fee. In New York, Apple Bank offers a rate of 15.8%.

These rates all come from relatively small banks that do not benefit from the savings associated with the economies of scale enjoyed by the larger card issuers. (Experts in the field agree that the more cards an issuer processes, the lower the unit cost of processing each card.) If Chevy Chase Savings & Loan or Union National Bank of Little Rock or Ranier National Bank in Seattle can charge below average rates, why don't the larger money center banks even come close? We believe the answer is because the large money center banks are cashing in on consumers' inability to find low-rate cards by pumping out plastic in national marketing campaigns.

FIFTH, CONSUMERS WILL ONLY BE PROTECTED FROM UNREASONABLY HIGH INTEREST RATES ON CREDIT CARDS IF LEGISLATION IS PASSED.

Federal legislation is no one's first choice as the best way to bring down high credit card interest rates. We fear, however, that without uniform national policy, banks will continue to threaten to move their credit card operations from any state seeking to protect its citizens from excessive charges.

I would now like to answer some of the claims made by the banking industry in defense of high interest rates on credit card balances:

CLAIM: Roughly 30% of consumers take advantage of the "free ride" by paying off their credit card bills in full each month. Therefore, consumers who maintain balances must pay higher interest rates in order to subsidize those who do not carry over charges.

RESPONSE: The banks used this argument very effectively in the late 70's and early 80's. They lobbied state legislatures to allow annual fees for credit cards to pay for the administrative costs associated with the card. We'd like to ask what the annual fee is now being used for, if not to pay for those administrative costs.

CLAIM: Credit card operations have only recently begun to make a profit and are now recouping the heavy losses incurred during the late 70's and early 80's, when the cost of money exceeded interest rate ceilings.

RESPONSE: First, it simply isn't fair to penalize consumers today for losses incurred and written off in years past. Second, if the cost of money was the major determinant of credit card profitability several years ago, why do banks now claim -- after their cost of money has dropped by 50% -- that administrative costs are a more important factor? Third, banks some time ago began collecting revenues through means other than the interest rate: the merchant discount fee, annual fees, transaction fees, service fees, late fees and, increasingly, interest charged from the date of purchase. How much is enough? We believe that failure to lower rates to fair levels can be attributed more to the banks' desire to make increased profits than to efforts to make up for previous losses.

CLAIM: Lower-income consumers will be pushed out of the credit card market if interest rates are lowered.

RESPONSE: We appreciate the banks' concern but in reality the situation that now exists is that many consumers have been given far too much credit.

Credit overextension has become a significant problem in our economy. The Foundation for Consumer Credit (a non-profit organization that counsels consumers with credit problems) reports an increase in the requests for counseling on problems related to credit card overextension. At the same time, they report that banks are less inclined to refer delinquent customers to them and more inclined to refer problem cases directly to debt collectors. The solution to freezing out higher risk consumers is not to charge higher interest rates to all cardholders; rather, such higher risk prospective cardholders can be offered collateralized accounts or accounts with lower credit limits.

CLAIM: Credit card fraud is on the rise; therefore, nigher interest rates are necessary to cover the extra costs associated with these losses.

RESPONSE: Fraud and credit losses together account for less than 1.2% of total losses, barely above the average levels of the last thirty years. According to the Wall Street Journal, the banks suffering higher losses are those which are so anxious to make big credit card profits that they're sending out cards without making sure of the creditworthiness of the recipients. It is important to note here that the bulk of losses from credit card fraud involve organized criminal activity. The two largest sources of fraud include: (1) the so called "white plastic" scheme in which real credit card numbers are embossed onto phony white plastic cards and then pushed through the system with the help of willing merchants, and (2) the scam involving phony telephone marketers who call with an offer and then use the card number for other purposes. Both types of fraud require large scale operations that have nothing to do with the average consumer's misuse of credit. Banks and their regulators must devise ways to address fraud where it exists at meaningful levels--penalizing organized crime, not ordinary citizens. We do not consider it an appropriate solution to simply pass those costs on directly to the consumer who is not responsible for such abuses.

* * *

As an organization representing credit card holders, we recognize the importance of ensuring that the credit card industry remains profitable; it is in all our interests to make credit available to the people who need it. We do not want to inhibit banks from competing. Our main concern is that consumers' legitimate needs are calculated into any profit equation.

In any legislation intended to protect consumers from unreasonably high credit card interest rates, we urge that you address the following issues:

1) Credit card interest rates should be tied to some economic index that reflects the cost to the banks of borrowing money, plus some margin allowing for costs and profits.

2) There should be improved disclosure laws in order to ensure the added competition that we feel should come as a result of this legislation. One possible danger we see in requiring banks to lower their rates is that they may seek to make up for the change by imposing "hidden fees". In reviewing several credit card applications, we have found that it is often very difficult to find the interest rate. It can also be difficult to discover when interest begins to accrue and when other charges may apply. We would like to see some requirement that banks make information more clearly evident in promotional material, including the annual fee, the interest rate, the method of calculation and the date upon which interest will begin to accrue.

Finally, I would like to thank the members of this Committee for recognizing the importance of ensuring an equitable credit card marketplace for the millions of consumers who have come to depend on credit cards as an alternative payment mechanism. The very fact that you are holding this hearing sends a strong signal to the public and to the banking industry that this issue will not be ignored.

Exhibit C.1 (continued)

Advance Balance."

Step 2: Go through the billing cycle shown on this statement one day at a time. For each day, take your "Old Advance Balance" and add any advances that have posted since the beginning of the cycle. Then subtract any payments or credits that apply towards advances and that have posted since the beginning of the cycle. (Remember that your payments and credits apply to finance charges and late charges before they apply to billed advances.) This gives you a daily balance for each day.

Step 3: Add all the daily balances obtained in Step 2 and divide the sum by the number of days in the billing cycle. This gives you your "average daily balance of advances."

Credit Card of a Virginia Bank: Bank B

To determine the Average Daily Balance, we start with the beginning balance in your Account each day (excluding unpaid Finance Charges and Annual Fee). To this amount we add new Cash Advances and depending on the amount and timing of your payment, we add new Purchases. If your previous balance is paid in full on or before the Payment Due Date shown on the preceding Billing Statement, then the new Purchases are added to the Average Daily Balance on the first day of the Billing Period following the new Purchases. We then subtract Payments and Credits. This gives us the daily balance.

Then, we add up all the daily balances for the Billing Period and divide the total by the number of days in the Billing Period. This gives us the Average Daily Balance.

Credit Card of an Out-of-State Bank: Bank C

Finance Charge Balance is the sum of the Average Daily Balances owing on your account during the billing period ending on the date of this billing statement, excluding any amount charged to your account as an annual fee and any unpaid Finance Charge. (Average daily balance means the sum of the balances owing in your account at the end of each day during a billing period divided by the number of days in the billing period. A separate average daily balance is calculated for each type of transaction at each applicable rate.) Purchases and advances are included in the balance owing on your account from the date BANK C posts each purchase or advance to your account up to the date payment is posted by BANK C.

Exhibit C.2

Billing Statements of Bank A

ACCOUNT NUMBER	CREDIT LIMIT	AVAILABLE CREDIT	DAYS IN BILLING CYCLE	BILLING CYCLE CLOSING DATE	PAYMENT DUE DATE	MINIMUM PAYMENT DUE
.....	800	114	30	10/18/84	11/12/84	34.00

DATE OF TRANS	DATE OF POST	REFERENCE NUMBER	CHARGES, PAYMENTS AND CREDITS SINCE LAST STATEMENT	AMOUNT
0922	0926	7824227.....	WILSONS MENS SHOP.....	267.88
0922	0927	7529100.....	STRIDE RITE BTRY.....	27.56
0922	1002	7848530.....	MISS HARPER.....	213.16
0922	1004	7520200.....	HAHN SHOES.....	47.84
1004	1004	F433500.....	ANNUAL FEE 10/84-06/85.....	11.25
1001	1015	7548530.....	MERRY GO ROUND.....	36.39
0922	1018	7548530.....	CHILDREN'S DISC MART.....	81.22

PREVIOUS BALANCE	PAYMENTS	CREDITS	PURCHASES AND ADVANCES	DEBIT ADJUSTMENT	FINANCE CHARGE	LATE CHARGE	NEW BALANCE
0.00	0.00	0.00	685.30	0.00	0.00	0.00	685.30

AN AMOUNT FOLLOWED BY A MINUS SIGN (-) IS A CREDIT OR A CREDIT BALANCE UNLESS OTHERWISE INDICATED

Send Inquiries To: .....

	ADVANCES	PURCHASES
ANNUAL PERCENTAGE RATES	18.00 %	18.00 %
PERIODIC RATES (MONTHLY)	1.500 %	1.500 %

1. Average Daily Balance of Credit Purchases	2. Average Daily Balance of Advances
0.00	0.00

MasterCard 7R

To avoid additional finance charges on Credit Purchases, you must pay the "New Balance" in full by the "Payment Due Date". Finance charges on Advances will accrue until the Advances have been paid in full.

NOTICE: See reverse side for important information.

Exhibit C.2 (continued)

ACCOUNT NUMBER	CREDIT LIMIT	AVAILABLE CREDIT	DAYS IN BILLING CYCLE	BILLING CYCLE CLOSING DATE	PAYMENT DUE DATE	MINIMUM PAYMENT DUE
.....	800	549	29	11/16/84	12/11/84	10.00

DATE OF TRANS	DATE OF POST	REFERENCE NUMBER	CHARGES, PAYMENTS AND CREDITS SINCE LAST STATEMENT	AMOUNT
11D2	11D2	7532540.....	PAYMENT - THANK YOU.....	500.30-
		FINANCE CHARGE *PURCHASES	$12.14 *CASH ADVANCE $0.00	12.14

PREVIOUS BALANCE	PAYMENTS	CREDITS	PURCHASES AND ADVANCES	DEBT ADJUSTMENT	FINANCE CHARGE	LATE CHARGE	NEW BALANCE
685.30	500.30	0.00	0.00	0.00	12.14	0.00	197.14

AN AMOUNT FOLLOWED BY A MINUS SIGN (-) IS A CREDIT OR A CREDIT BALANCE UNLESS OTHERWISE INDICATED

Send Inquiries To .....

	ADVANCES	PURCHASES
ANNUAL PERCENTAGE RATES	18.00 %	18.00 %
PERIODIC RATES (MONTHLY)	1.500 %	1.500 %

1. Average Daily Balance of Credit Purchases	2. Average Daily Balance of Advances
810.00	0.00

MasterCard 7R

To avoid additional finance charges on Credit Purchases, you must pay the "New Balance" in full by the "Payment Due Date". Finance charges on Advances will accrue until the Advances have been paid in full.

NOTICE: See reverse side for important information.

Source: Consumer complaint files of Virginia's State Office of Consumer Affairs.

STATEMENT OF

THE CONSUMER BANKERS ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS

OF THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

FEBRUARY 11, 1986

The following are the views of the Consumer Bankers Association1/ on the primary issue of the hearings held on Tuesday, January 28, 1986, before the Subcommittee on Financial Institutions and Consumer Affairs of the Senate Banking, Housing and Urban Affairs Committee: whether the federal government should impose rate limitations on credit card programs. For reasons set forth below, we are strongly opposed to such proposals. We request that our views be made part of the record of the hearings.

We believe that consideration of several points illustrates why legislative intervention to set a ceiling on credit card interest rates will not produce the desired result. First, our national experience demonstrates that price restrictions reduce the availability of credit for many otherwise creditworthy individuals. Second, the current market for credit card services is robust and highly competitive, and not reflective of the monopolistic situations generally associated with governmental intervention in market processes. Third, "credit card" lines of credit are fundamentally different from conventional commercial,

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1/ The Association is a nonprofit organization that was organized in 1919 to provide a voice for the retail banking industry. Today, membership in the Association is open to any federally insured depository institution, including commercial banks, thrifts, and credit unions. Associate members include bank card processors and service provider organizations. Combined, the members of the Association now hold over 70% of all consumer credit outstanding held by commercial banks and over 80% of the consumer deposit accounts held by commercial banks.

mortgage, or installment loan products and comparisons between these various forms of credit are misleading. Further, fluctuations in indicators such as the "prime" rate, the "discount" rate, and the Internal Revenue Service late return rate are poor determinants of the appropriate level of credit card interest rates. Finally, analysis indicates that banks and other credit card lenders are not reaping excessive profits on their credit card operations.

I. CREDIT IS MOST FAIRLY AND EFFICIENTLY ALLOCATED BY MARKET MECHANISMS.

The proposed legislation would impose price controls in the form of national rate limitations on the amount of interest credit card issuers may charge consumers. The American economy has long been characterized by a free market operating without government interference, except in circumstances where clear economic or social justification has been shown for such intervention. Although our national history contains instances where price controls were adopted, generally they have failed to work because the cost to society of such controls has proved greater than the benefit.

Artificial price controls are now generally regarded as unacceptable mechanisms for allocating or pricing goods and services. Usury laws are nothing more than price controls that impose specific limitations on the

price (reflected as interest) paid for a specific commodity (the use of money).

As a form of price control, usury limits are considered to be inefficient and unfair as they produce inappropriate social and economic dislocations. For example, money that would in effect be "sold" to borrowers willing to pay higher interest rates is perforce allocated to other "purchasers" who value it less.

Moreover, when lenders and other creditors are unable to charge prices for credit services that are commensurate with their costs, the supply of available credit contracts. In rate-controlled environments creditors respond to interest rate limitations by reducing the costs of extending credit and one means of reducing costs is to limit credit only to lowest-risk consumers. Therefore, borrowers who could obtain credit in an unregulated market must go without.

Legislation to cap rates would have an adverse affect on the American economy because creditors would be forced to restrict access to what is probably the most widely available form of consumer credit in the United States. Credit cards are often the best opportunity for consumers, particularly younger people, women, minorities and the less affluent to develop good credit histories and ratings that in turn make them eligible to participate equally in our economy. Without such credit histories, these people would find it more difficult to obtain loans to

buy cars, furniture or a home. They may also find it difficult to rent a car, reserve theater and airline tickets or get a hotel or motel room. In addition, credit cards can help consumers manage their money better, as they are a major source of sales for retail stores, gas stations, and other businesses. In turn, credit sales stimulate the economy and employment in banking, retailing and other sectors of business.

Price controls are generally regarded to be the most justifiable where the free-market does not function properly, as when the market is a monopoly. Accordingly, governmental intervention of the type represented by the proposed legislation should legitimately be called for only where a market assumes monopolistic characteristics and competition ceases to operate. As our discussion below indicates, such circumstances are clearly absent from the current credit card market in the United States.

II. THE CURRENT MARKET FOR CREDIT CARD SERVICES IN THE UNITED STATES IS HIGHLY COMPETITIVE.

Imposition of a federal ceiling on credit card interest rates would be a useful measure only if there were significant evidence of a widespread lack of competition between banks and other credit card issuers in providing credit services to the American public. Such an environment certainly does not exist in the United States at present. Indeed, more than 15,000 financial institutions, such as banks, saving and loans and credit unions currently provide

some type of credit card program. In addition, such services are offered by a broad cross-section of corporate institutions, such as retail stores, finance companies, travel and entertainment card issuers (e.g., American Express), oil companies and others. A number of competing credit cards are now available in every market area. Moreover, the recent entrance of numerous additional competitors into the credit card field such as Sears (with its new nationwide Discover card), Shell, and Household International is evidence not only that the current credit card market is a dynamic, constantly changing arena where numerous institutions are presently competing for a finite number of customers, but also that another characteristic of competitive markets exists in the credit card industry: potential competitors are poised to enter the market, bringing new products and additional competition.

In order to attract consumers, card issuers are currently engaging in aggressive marketing efforts searching for new accounts through solicitations that are not only local, but also national in scope. Credit card issuers offer numerous, differing and attractive options for consumers. This large number of suppliers in the market is a clear indication of the existence of robust competition. Under such circumstances, no credit card issuer, or group of issuers, could maintain a position of monopoly power.

We need not rely either on the everyday experience of U.S. consumers or on the views of private economists for

confirmation of the vigorously competitive nature of the credit card industry. The United States Department of Justice and the federal judiciary, as well as private economists, rely on an analytical tool referred to as the Herfindahl-Hirshman Index. Applying the Justice Department's analytical tool to the credit card industry produces crystal clear, unambiguous results. There is no monopoly, no oligopoly, no high concentration of the market. The credit card industry, quite contrary to allegations by some, is characterized by extremely low concentration and vigorous competition. The current level of credit card interest rates, then, clearly is attributable to factors other than lack of market competition.

III. CURRENT CREDIT CARD INTEREST RATES REFLECT VALUABLE SERVICES AND SPECIAL CREDIT FEATURES PROVIDED BY CREDIT CARD ISSUERS.

The extension of credit through credit card mechanisms is a relatively recent phenomenon. It is a service that has generated enormous positive benefits for both our credit markets and the average American consumer. For consumers, credit cards are a simple, convenient and efficient means of payment and credit access.

A. Services Provided to Consumers.

Credit card plans provide qualified consumers with an unsecured, revolving line of credit recognized by, and usable at, tens of thousands of merchants and financial institutions worldwide. Terms of repayment are flexible and

largely at the discretion of the cardholder. A consumer carrying a bank credit card, for example, can make a series of purchases of goods and services at different locations during a month and then receive and pay a single bill on which each seller is identified. This payment mechanism is safe, since federal laws limit losses to the consumer from a lost or stolen credit card to $50. Increasingly, credit cards also provide consumers with quick and easy access to cash 24 hours a day, seven days a week through a nationwide network of automated teller machines. Moreover, credit cards are invaluable as identification for check cashing, hotel registration, car rentals, and other important services. These worldwide, conveniently available services involve complex, sophisticated operational and legal arrangements that were costly to create and are costly to maintain.

These services and protections are provided to credit card consumers whether the charge card is used as a payment or a credit mechanism. Moreover, the credit card holder determines whether, and to what extent, the credit feature of the card service is employed. For example, almost all credit card plans charge interest on purchases only if cardholders pay less than the full amount billed to the account during the billing period.

Currently more than one-third of all credit card users pay off their entire account balance when billed. These cardholders therefore receive -- at no direct cost -- free credit from the date of purchase to the date the

payment must be made, while paying no finance charges to the card issuer to offset the costs of establishing and maintaining their accounts. Because of the existence of this payment "grace period," the effective annual rate of interest charged to credit card holders who incur a finance charge is considerably less than the advertised or disclosed annual percentage rate.

This concept is best illustrated through an example. Assume a 30-day billing period ending on the last day of each month. If a credit card holder uses his credit card on January 5th to make a $100 purchase, under the terms of most credit card arrangements, he would receive an interest-free 25-day grace period from January 5th until January 30 before his purchase is billed on his credit card statement. Once this charge is billed, he may also receive another 20 to 25-day grace period before his payment for the purchase is due. If he decides to pay his account balance in full before the payment due date, he has received a 45 to 50-day interest- free loan of $100.

The effect of these interest-free periods on a card issuer's return on operations and on real cost to consumers is significant. Studies done by the Credit Research Center at Purdue University indicate that the actual yield to creditors from their credit card operations is significantly less than the APR required to be disclosed to consumers under federal law. Sample surveys indicate that effective yields for retailers are only 84% of

Table C.3

Calculation of Average Daily Balances by Three Banks

Date of Posting	Item	Balance Bank A	Balance Bank B	Balance Bank C
9.19		$ 0	$0	$ 0
9.20		0	0	0
9.21		0	0	0
9.22		0	0	0
9.23		0	0	0
9.24		0	0	0
9.25		0	0	0
9.26	Purchase $267.88	267.88	0	267.88
9.27	Purchase 27.56	295.44	0	295.44
9.28		295.44	0	295.44
9.29		295.44	0	295.44
9.30		295.44	0	295.44
10.1		295.44	0	295.44
10.2	Purchase 213.16	508.60	0	508.60
10.3		508.60	0	508.60
10.4	Purchase 47.84 Annual fee 11.25	567.69	0	556.44
10.5		567.69	0	556.44
10.6		567.69	0	556.44
10.7		567.69	0	556.44
10.8		567.69	0	556.44
10.9		567.69	0	556.44
10.10		567.69	0	556.44
10.11		567.69	0	556.44
10.12		567.69	0	556.44
10.13		567.69	0	556.44
10.14		567.69	0	556.44
10.15	Purchase 36.39	604.08	0	592.83
10.16		604.08	0	592.83
10.17		604.08	0	592.83
10.18	Purchase 81.22	685.30	0	674.05
10.19		$ 685.30	$ 674.05	$ 674.05
10.20		685.30	674.05	674.05
10.21		685.30	674.05	674.05
10.22		685.30	674.05	674.05
10.23		685.30	674.05	674.05
10.24		685.30	674.05	674.05
10.25		685.30	674.05	674.05
10.26		685.30	674.05	674.05
10.27		685.30	674.05	674.05
10.28		685.30	674.05	674.05
10.29		685.30	674.05	674.05
10.30		685.30	674.05	674.05
10.31		685.30	674.05	674.05
11.1		685.30	674.05	674.05
11.2	Payment $500.30	185.00	674.05	190.67
11.3		185.00	185.00	190.67
11.4		185.00	185.00	190.67
11.5		185.00	185.00	190.67
11.6		185.00	185.00	190.67
11.7		185.00	185.00	190.67
11.8		185.00	185.00	190.67
11.9		185.00	185.00	190.67
11.10		185.00	185.00	190.67
11.11		185.00	185.00	190.67
11.12		185.00	185.00	190.67
11.13		185.00	185.00	190.67
11.14		185.00	185.00	190.67
11.15		185.00	185.00	190.67
11.16		185.00	185.00	190.67
End of October billing cycle				
Total		$11,504.41	$0	$11,335.66
Average		383.48	0	377.86
End of November billing cycle				
Total		$12,369.20	$12,700.75	$12,296.75
Average		426.52	437.96	424.03

Bank A: Average daily balance for the November billing period obtained using the steps listed in Exhibit C.1. The results are as follows: Step 1, $0; Step 2, $685.30; Step 3, $12,369.20; Step 4, $426.52; Step 5, $11,504.41; Step 6, $383.48; and Step 7, $810.00.

Bank B: Average daily balance for the November billing period is $437.96.

Bank C: Average daily balance for the November billing period is $424.03.

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disclosed APR's. Similarly, effective yields for banks represent only 83% of quoted rates. Consequently, if the disclosed rate on a bank card is 18%, the actual yield to an average bank would be approximately 14.94%. Another way of expressing this same phenomenon is that the average real price of credit to that bank's customers as a group is also 14.94%. These insights into the actual yield creditors achieve when the grace period is taken into account should play an important role in any discussion or consideration of the issue of credit card rates. Direct comparisons between the rates for open-end credit card programs and for other forms of credit, even other consumer credit rates, cannot be made without an adjustment for the free period. To reach a policy resolution solely based on the disclosed rates is to base policy on a badly distorted economic analysis.

This interest-free grace period, as well as the numerous other costly convenience features noted above, is unique to the credit card market, and indicative of the valuable services efficiently provided to consumers by the credit card industry. It also renders comparisons of rates available in other forms of credit quite inappropriate.

B. Costs of Credit Card Services to Issuers.

Credit card services are provided to American consumers at a high cost to our credit card industry. Over the past 10 years, the cost of funds has represented only about thirty percent (30%) of total credit card costs for bank issuers. This amount contrasts sharply with comparable

cost-of-funds figures for other types of lending by banks, such as mortgage lending and commercial lending, for which the costs of funds as a percent of total costs equals 90% and 75%, respectively. The additional non-financing costs, unique to the highly competitive credit card market, are the result, in part, of the industry's continuing investment in a massive telecommunications and labor infrastructure in order to provide consumers with safe and secure credit card access. This bears some elaboration.

Distinctions between credit card and other types of credit plans are apparent even in the application stage. Verifying the creditworthiness of a large volume of applicants, approving applications and issuing cards requires credit card issuers to maintain a highly skilled labor force trained to expedite this process in order to swiftly respond to consumer needs.

Similarly, there are significant transaction costs associated with consumer use of credit cards at the point of sale. Participating merchants must, in most cases, seek authorization from the card issuer in order to complete the transaction. Increasingly, authorization is provided to the merchant through electronic means. While this procedure drastically improves card and system security, investment in such technology continues to be costly for the credit card industry.

Additional telecommunications expenditures are required to transmit sales data from merchants, who normally

deposit their receipts in local banks, to the card-issuing bank, which in many cases is in a different region of the country.

The billing and payment process, in which thousands of billing statements are computed, printed and mailed to consumers on a monthly basis, requires specialized equipment and substantial recurring expenses. Additional personnel are needed to resolve alleged errors in billing statements in accordance with the strict procedures and time frames mandated by federal law. Some CBA members indicate that 25% of their card-issuing workforce is committed to this customer service activity alone.

These costly expenditures produce an efficient and convenient credit card system. Unfortunately, these measures increasingly must be supplemented with efforts to curb the high costs of credit card fraud and counterfeiting. Fraud losses are alarmingly high, although the industry is doing all it can to contain fraudulent activity. For example, in 1973, total fraud losses for MasterCard members were $2,700,000. By 1984, that figure had escalated to over $78,000,000. The burgeoning incidence of organized credit card fraud (especially regarding counterfeit cards) in recent years has added significantly to the cost of providing the card service. The card industry is developing various security measures to help alleviate the problem of fraud. Some of these new security measures include holograms, perforated or carbonless sales slips, lower floor

limits for some merchants, and on-line authorizations for all transactions. All of these new security measures add significantly to a card issuer's operating costs.

These costs are real and continuing obligations that competitors in this industry must pay in order adequately to serve the consuming public. The credit card industry involves predominately modest sized lines of credit, high transaction volume, extensive data communications and computer technology, and extraordinary consumer protection. Few of these features exist in auto loans, home mortgages or other forms of consumer credit. A relatively higher level of interest charge for credit cards is thus hardly unexpected or unjustified. Again, these costs are unique to the credit card industry because the convenience the industry provides is exceptional and the costs are reflected in the current rate of interest charged to card customers.

IV. BANKS AND OTHER CREDIT CARD ISSUERS ARE NOT MAKING EXCESSIVE PROFITS ON THEIR CREDIT CARD OPERATIONS.

Proponents of the legislation directed at rate limitations have argued that credit card issuers are currently reaping "excessive" profits on their card operations. An analysis of the credit card market belies this assertion: there is much evidence that profits are not excessive and there is no evidence to the contrary.

Historically, there has been relatively little vacillation in the annual percentage rate charged by issuers

on their credit cards. During the period 1972-1984, average APR's on credit cards fluctuated between 16.5 and 19.0%. This relative stability in credit card interest rates may be attributed to two major factors: (1) the relatively small impact of the cost of funds in the overall cost equation for credit cards as compared to commercial or larger-dollar consumer loans; and (2) the distorting effect of statutorily imposed state ceilings on interest rates.

Over this same period, average before-tax earnings for credit card operations were significantly lower than for commercial or mortgage lending. During the late 1970's and early 1980's, with financing costs at unprecedented high levels, credit card issuers were unable to raise card rates to reflect their true expenses because of state-imposed usury ceilings. The result was a period of extremely low or negative profit margins on credit card activities and a restriction on credit available in some jurisdictions. Many banks and other credit card issuers nevertheless maintained the rather unprofitable product line through difficult times, while seeking legislative relief from state interest rate caps.

The existence of these rate caps created unnecessary hardships for American consumers during the period 1979-1982. In order to maintain marginal profitability, credit card issuers were forced to cut costs through such measures as charging annual fees for card accounts, tightening lending standards, and shifting their focus from the

credit card business to other, more profitable lending activities. Consumers, particularly those seeking credit for the first time, thus were affected adversely by artificial constraints placed on the credit card industry.

The media is filled with rate comparisons offered by advocates of governmental intervention, which purport to demonstrate excessive profits. A typical example used is that of a large lender for whom the interest rate "spread" between the prime rate and his advertised rate of 18% in 1981 was 1/2%, while in 1985 the lender advertises a 19.8% APR despite the substantial drop in the prime rate. So it is alleged this lender's APR should have dropped by 2%. The example is deceptively attractive to demonstrate that the lender is making a comfortable profit, by virtue of the increase in the spread between 1981 and 1985. The analysis is badly flawed, however. First, the prime rate is an inappropriate rate to use for profit analysis. Second, and more importantly, the years 1980 and 1981 were disastrous years for credit card issuers. VISA members alone lost $188 million and $132 million respectively in those two years. Hence, the intimation that the 1985 "spread" is indicative of excessive profits because it is large in comparison to a period of enormous losses simply has no merit.

With their credit card activities regaining an acceptable level of profitability, card issuers have been able aggressively to pursue new business, thereby expanding greatly the amount of credit available to consumers. In the

present regulatory environment, this has proved a prudent short-term response to changing economic conditions. Federal disclosure legislation requires card issuers to give notification to customers 15 days prior to the effective date of any rate increase. Many states impose more extensive notice requirements. With the shadow cast over financing rates by the immense federal budget deficits, credit card issuers understandably are skeptical whether current favorable conditions will persist. Some money-center banks, such as Manufacturers Hanover and Bank of New York, have moved to lower significantly the APR's on their accounts. As long-term economic prospects become more certain, other credit card issuers may also adjust their rates.

Although there have been some market adjustments to credit card interest rates in response to lowered cost of funds, it is important to note that banks have responded to changing economic circumstances in ways not reflected in credit card interest rate shifts. For example, banks are now making available to their card customers from independent vendors new services such as card registration, common carrier travel accident insurance, automobile clubs, discounts on airfares, car rentals and hotel accommodations, and rebates on merchandise purchased through bank credit cards. The value of these services is considerable. They represent a better card product at the same price, the economic equivalent of a price reduction. Considering the enormous non-financing costs associated with the industry,

the unsecured nature of the credit extended, and the uncertainty of the present economic environment, current credit card interest rate levels reflect a realistic determination by card issuers of the costs associated with their product. The rates of return are by no means excessive.

V. CONCLUSION.

Today the credit card market is highly competitive, robust and dynamic, and continues to provide convenient, valuable and efficient service to consumers at prices reflecting industry costs. Cardholders are well aware of current interest rate levels. The continuing growth of the industry indicates that, on balance, the value of the services offered by the card industry is adequately reflected in the rates currently prevalent in the industry.

Federal rate limits would have a disruptive effect on industry flexibility in these uncertain economic times. Price controls on credit cards can reduce rather than increase competition as creditors withdraw from the market and limit consumer choices and credit availability. Retailers and their suppliers may also suffer as credit sales decline and employment is curtailed. On balance, the negative effects of price controls on credit cards far exceed any perceived benefits. For these reasons, the Consumer Bankers Association respectfully urges Congress to reject rate limits on credit cards.

Written Testimony of

Michelle Meier
Counsel for Government Affairs
CONSUMERS UNION OF U.S., INC.

on S. 1922 and S. 1603

Submitted to

FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS SUBCOMMITTEE

of the

SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

February 12, 1986

Consumers Union* appreciates the opportunity to submit written testimony on S. 1922 and S. 1603, which both address the problem of high credit card interest rates. We support the general thrust of the bills, and we applaud Senators Hawkin and D'Amato for their leadership in this area.

In 1984, our organization conducted a survey of 133 large and medium-sized banks coast to coast in which we collected information on the rates, annual fees and availability of their credit cards. Although we found a few banks that offered lower rates, most rates hovered between 18 and 21%. Our findings comport with the figures of the Federal Reserve Board, which has published data showing an average rate in November, 1984, among a sampling of commercial banks of 18.8%. The few lower rates we found were at the smaller banks that do not aggressively solicit new customers and, in most cases, do not market their cards nationwide. The largest banks, which had

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*Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide information, education, and counsel about consumer goods and services and the management of the family income. Consumers Union's income is derived solely from the sale of Consumer Reports, its other publications, and films. Expenses of occasional public service efforts may be met, in part, by nonrestrictive, noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports, with over 3.0 million circulation, regularly carries articles on health, product safety, marketplace economics, and legislative, judicial, and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

the highest rates, engage in massive direct mail campaigns to account for the millions of cardholders each has nationwide.

Our conclusion from the information we obtained in the course of the survey is that there is very little price competition in the credit card industry. This is an unsurprising example of what many economists believe to be true of the consumer credit market generally. In interviews we have held with economists at the Federal Reserve Board, they have stated that demand in the consumer loan market is not very sensitive to price, but to general economic conditions. In other words, when consumers feel confident about the future and their job security, they spend and borrow. When the economy appears headed for a recession, they pull back. Given the limited financial resources of the average household unit, this behavior is not unexpected or unreasonable.

A similar view was expressed in the 1983 testimony before a subcommittee of the House Banking Committee of Manuel Johnson, who was then the Assistant Secretary for Economic Policy of the Treasury Department:

> Consumer loan rates are generally considered to be administered rates. That is, they are posted by lenders rather than set by the market interaction of supply and demand conditions...S. Hrg. 98-73, March 17, 1983, p. 19.

These theories conform with the facts. Although market rates have fluctuated extremely during the past decade, consumer credit rates on 2-year installment loans, for example, have generally stayed on a relatively high, steady course.

Charge card rates have been even more unresponsive to the market rate fluctuations, although in a competitive industry, one would expect prices to fluctuate with industry costs. (See Tables in Appendix A and B)

In sum, there are inherent limits on the competitiveness of the consumer credit market because of the nature of consumer spending. Consequently, lenders are free to set higher rate and other prices than a competitive market would allow.

Even assuming there is some margin of competitiveness in the consumer credit market generally, one characteristic of the credit card market in particular puts further restraints on competition. That is, all credit cards effectively have variable rate and other price features that allow unlimited price increases. Even if a consumer attempts to purchase a card with favorable price terms, he has no guarantee that those terms will stay in effect for any significant length of time. Although the issuer has to give 15 days notice of a rate increase, for example, the consumer confronted with the increase is deterred from shopping for a new card because he has already paid his non-refundable annual fee. Further, he has no guarantee that the lower rate of an alternative card will last. Unless legislation is enacted to require banks to fix their price and other terms throughout the membership period, this characteristic of the credit card market will continue to place great restraints on competition.

Aside from this factor, the minimal margin of competition inherent in the credit card market is further impaired by the lack of timely information available to consumers for

comparison shopping. The Truth-in-Lending regulations that apply to open-end credit do not require disclosure of the pertinent information needed to comparison shop until the card issuer has already accepted the completed application and the plastic is in the consumer's hand. The regulations state:

> The creditor shall furnish the initial disclosure statement . . . before the first transaction is made under the plan. 12 CFR section 226.5(b)(1).

According to the Official Staff Commentary on Regulation Z, lenders may even collect a membership fee, or require the consumer to agree to pay such a fee, before the disclosures are given. This may occur "as long as consumers, after receiving the disclosures, can reject the plan," in which case the consumer is due a refund. Board of Governors of the FRS, Official Staff Commentary on Regulation Z Truth-in-Lending at p. 26 (Oct. 16, 1984).

This timing requirement puts the cart before the horse. The disclosure of rate and other charges should come before a consumer goes to the trouble of applying for a card so that he can comparison shop. If the consumer learns of a high rate after his account is already opened, he is unlikely to assume that he can get an annual fee refund, and the regulations do not require the lender to inform him of that fact. Even if the disclosure is made, the consumer must deal with the issuer's bureaucracy and red tape to get his refund and a cleared account.

It would be far more logical and efficient to require all disclosure of important price and term information at the time the initial application is given to the consumer. Otherwise, consumers have the double burden of not only submitting an initial application, but of mailing the rejected card back with an explanatory letter and waiting for his refund. All of this time and activity is required just to learn that the terms of the credit card plan are not favorable. The timing of the Truth-in-Lending disclosures certainly acts as a deterrent against comparison shopping and competition.

RECOMMENDATIONS

Because there is minimal competition in the credit card industry, we endorse the concept of a floating federal rate cap. A federal cap is particularly appropriate because of the interstate market in which the industry operates. State caps permit issuers to go to South Dakota or other states where they are free to market their cards nationwide.

The caps should be set at a rate that allows issuers to earn a reasonable profit, and the index on which the caps are based should probably be appropriate to the amortization term on which credit card minimum payments are based. We have not reached any conclusions on these issues, but we would be happy to work with the Subcommittee to resolve them.

We also heartily recommend immediate legislation to improve the availability of the information that is necessary to rationalize the market. Not only must all the pertinent

information be available before a consumer submits his application, but the advertising regulations must be slightly expanded to require the disclosure of penalty fees and grace periods.

The disclosure provisions included in section 3 of S. 1922 are a major step forward insofar as they state that the disclosures must be made on initial applications for a credit card. However, the disclosures are not sufficient for comparison shopping purposes. Aside from the annual percentage rate and annual fee, other significant terms, such as grace periods, must be disclosed with the initial application. Generally, the content of the "initial disclosures" required by the Truth-in-Lending regulations (12 CFR section 266.6) are good. We only recommend that they be supplemented by a requirement to disclose the period during which any rate, even one that is not technically a variable rate, will be in effect. With this modification, the provisions of the regulation could be incorporated into the bill. The important effect would be to move the timing of the disclosures now required forward to the time of initial application.

A final recommendation is to require that banks use a standard balance method on which to compute interest. The effect of varying balance methods is not something consumers can easily calculate when they are comparison shopping. To standardize the balance method would enhance competition by allowing consumers to compare apples with apples so that they have the ability to choose the account with the best price.

Interest rates

Yr/Mo.		24-Mo. Personal Loans	Credit Card	Federal Funds	Discnt Rate	Prime Rate	1-year Trsry Secrts.	Cost of S&L Funds	Fixed Mortgage Rates
1972	FEB	12.50	17.13	3.29					
	MAY	12.44	17.24	4.27					
	AUG	12.47	17.25	4.80					
	NOV	12.44	17.23	5.06					
1973	FEB	12.51	17.16	6.58					
	MAY	12.48	17.22	7.84					7.72
	AUG	12.66	17.22	10.50					7.93
	NOV	12.75	17.23	10.03					8.40
1974	FEB	12.82	17.24	8.97	7.5	9.5	6.88		8.62
	MAY	12.88	17.25	11.31	8.0	10.86	8.78		8.75
	AUG	13.11	17.17	12.01	8.0	12.0	9.36		9.10
	NOV	13.16	17.16	9.45	8.0	11.14	7.66		9.31
1975	FEB	13.20	17.24	6.24	6.75	9.14	5.98		9.16
	MAY	13.11	17.21	5.22	6.25	7.5	6.39		8.91
	AUG	13.05	17.14	6.14	6.0	7.5	7.70		8.90
	NOV	12.96	17.06	5.22	6.0	7.5	6.49		9.00
1976	FEB	13.02	17.14	4.77	5.5	6.75	5.91		8.95
	MAY	12.96	17.02	5.29	5.5	6.75	6.40		8.97
	AUG	13.02	17.01	5.29	5.5	7.0	6.00		9.01
	NOV	13.06	17.04	4.95	5.5	6.5	5.29		9.05
1977	FEB	12.95	16.89	4.68	5.25	6.25	5.47		8.99
	MAY	13.00	16.87	5.35	5.25	6.25	5.84		8.96
	AUG	12.87	16.86	5.90	5.25	6.75	6.37		9.02
	NOV	13.06	16.92	6.51	6.0	7.75	6.95		9.07
1978	FEB	12.94	16.90	6.78	6.5	8.0	7.34		9.18
	MAY	13.11	16.97	7.36	6.5	8.21	7.82		9.37
	AUG	13.30	17.10	8.04	7.25	9.0	8.31		9.70
	NOV	13.42	17.16	9.76	9.5	10.61	10.01		9.87
1979	FEB	13.59	17.05	10.06	9.5	11.75	10.24		10.20
	MAY	13.65	17.06	10.24	9.5	11.75	10.12	7.35	10.47
	AUG	13.76	17.09	10.94	10.0	11.75	9.98	7.49	11.01
	NOV	14.39	16.93	13.18	12.0	15.25	12.39	7.77	11.37
1980	FEB	14.69	17.13	14.13	12.0	15.25	13.92	8.29	11.93
	MAY	16.31	17.31	10.98	13.0	18.39	9.39	9.50	13.68
	AUG	15.33	17.39	9.61	10.0	11.0	10.24	8.98	12.25
	NOV	15.54	17.41	15.85	11.0	15.3	14.15	8.68	13.04
1981	FEB	17.14	17.58	15.93	13.0	19.5	14.57	9.82	13.54
	MAY	17.48	17.71	18.52	13.29	18.43	16.20	10.59	14.10
	AUG	18.52	17.78	17.82	14.0	20.5	16.72	10.76	15.27
	NOV	19.21	18.04	13.31	13.0	17.29	12.41	11.68	16.38
1982	FEB	18.76	18.14	14.78	12.0	16.5	14.73	11.26	15.12
	MAY	18.90	18.41	14.45	12.0	16.5	13.34	11.39	15.89
	AUG	18.93	18.73	10.12	11.0	15.0	11.43	11.50	15.68
	NOV	17.99	18.75	9.20	9.5	12.0	9.16	10.62	13.81

Yr/Mo.		24-Mo. Personal Loans	Credit Card	Federal Funds	Discnt Rate	Prime Rate	1-year Trsry Secrts.	Cost of S&L Funds	Fixed Mortgage Rates
1983	FEB	17.47	18.82	8.51	8.5	11.0	8.92	9.75	13.16
	MAY	16.57	18.79	8.63	8.5	10.5	8.90	9.62	12.67
	AUG	16.28	18.75	9.56	8.5	10.5	10.53	9.81	12.38
	NOV	16.39	18.75	9.34	8.5	11.0	9.94	9.82	12.34
1984	FEB	16.16	18.73	9.59	8.5	11.0	10.04	9.73	12.23
	MAY	16.35	18.71	10.32	9.0	12.0	11.66	9.74	12.18
	AUG	16.75	18.81	11.64	9.0	13.0	11.82	10.01	12.43
	NOV	16.63	18.82	9.43	9.0	12.0	9.82	10.04	12.75
1985	FEB	16.21	18.85	8.50	8.0	10.5	9.29	9.40	12.21
	MAY	16.09	18.74	7.97	8.0	10.5	8.46	9.19	12.01
	AUG	15.84	18.62	7.90	7.5	9.5	8.05	8.77	11.24
	NOV	15.61	18.57	8.05	7.5	9.5	7.88		

24-month personal loans
Credit card plans
Average APR at reporting commercial banks for first full week of month
Feb 72 - Feb 82 -typed sheet in file; source appears to be FR Bulletin
May 82 - -FR Bulletin and G.19 statistical release

Federal Funds Rate
Bank-to-bank overnight loans of excess reserves on deposit at Federal Reserve; fluctuations reflect market cost of funds
Feb 72 - Nov 82 -FRB printout of average of daily figures
Feb 83 - -Average of daily figures from G.13 statistical release

Discount Rate
Charged by FRB for short-term borrowing by banks; set by FRB in part to influence general economic trends and monetary policy; figures are for NY Fed
Feb 74 - Nov 82 -Average for first full week of month, from untitled sheets
Feb 83 - -Average for first full week of month, from G.13 release

Prime Rate
Sources same as for Discount Rate

One-Year Treasury Securities
Constant maturities; monthly average yields as calculated by FRB (not auction rate for one-year bonds). Source is G.13 release. Most common ARM index

Savings and Loan Cost of Funds
FHLBB

Fixed Mortgage Rates
FHLBB -- for conventional fully amortized first mortgages, including fees and charges, single-family homes, first five working days of the month

ELECTRONIC FUNDS TRANSFER ASSOCIATION
SUITE 3000 1726 M STREET N.W. WASHINGTON, D.C. 20036 (202)659-4100

February 10, 1986

The Honorable Slade Gorton
Chairman
Financial Institutions and Consumer Affairs Subcommittee
Committee on Banking, Housing and Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

The Electronic Funds Transfer Association[1] is pleased to submit its views on pending legislation to cap interest rates on credit cards. During the January 28 hearing before the Subcommittee, there was a great deal of discussion on whether or not credit card rates were too high. However, little or no attention was given to the growing value of the card as it has evolved from a basic piece of plastic that permits the holder to use a line of credit, to a device that enables consumers to conveniently access a full line of financial products and services. For the reasons stated below, the Electronic Funds Transfer Association is opposed to S. 1603, S. 1922, and similar legislative proposals that restrict the pricing of cards or card services. We request that our views be made part of the hearing record.

Any discussion of rates, fees or other means of pricing card services should consider the increased "value-added" to the basic credit card. Today, the electronic portion of the card business involves the paperless processing and transfer of information and funds. Since the electronic aspects of card services are increasing daily, the credit card is becoming a significant part of electronic funds transfer (EFT) systems. For example, both credit and debit cards are used to access funds via automatic teller machines (ATMs) and to purchase goods and services at retail point-of-sale (POS) locations.

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1. The Electronic Funds Transfer Association is the only national multi-industry organization committed to addressing the broad range of issues affecting the rapidly evolving EFT field. The Association's members include large and small commercial banks, thrift institutions, credit unions, department stores, oil companies, data processing firms, equipment and software manufacturers, telecommunications companies and shared EFT networks.

Today, consumers use their cards at more than 50,000 ATMs, located throughout the United States, primarily to obtain cash from their bank deposit or credit accounts. Consumers also make extensive use of their credit cards to purchase goods and services at the point-of-sale from retail merchants, hotels, car rental firms and many other businesses. Now, cardholders may also choose to debit such transactions to their deposit or credit accounts. As with ATM use, the added convenience and cash savings of such debit transactions may offset the loss of a grace period of 25 days or more. In fact, consumers may choose between using their cards in a credit, debit or information access mode. Consequently, the term "credit card" is becoming a misnomer since it does not describe the many other functional capabilities and uses of the card. A more accurate description is "access card" or "payments system card."

Regardless of the name, the "card" is changing in many ways. The application of new technologies such as watermark and signature dynamics can help to improve the security of card transactions. So called "chip" cards which include integrated circuitry and semiconductor chips are broadening the spectrum of card applications. There are already signs that the card is evolving into a device that will permit consumers to conveniently optimize their financial needs for credit, savings, investments, insurance and other financial products and services.

In summary, the Electronic Funds Transfer Association believes that consumers are receiving increasingly valuable services for the prices they pay to use their cards. Competition is driving card providers to invest heavily in more advanced technologies to improve the cost-effectiveness of card services, to provide more consumer choices, and to broaden the uses for the card. Legislated price restrictions will dampen the incentive to innovate and reduce competition among financial services providers to the detriment of consumers. For these reasons, the Electronic Funds Transfer Association opposes efforts to restrict rates, fees, or charges on cards and we urge Congress to reject such proposals.

I appreciate the opportunity to present the views of the EFT Association. I hope that we may be of further help to you and your efforts in the future.

Sincerely,

Dale L. Reistad

Dale L. Reistad
President and Chief Executive Officer

cc: All members of the Subcommittee on Financial Institutions and Consumer Affairs

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FACT SHEET

ELECTRONIC FUNDS TRANSFER ASSOCIATION

The EFT Association was founded in 1977 to carry on the role of the Congressionally-mandated National Commission on Electronic Fund Transfers to act as a multi-industry forum for the discussion of EFT issues. EFTA is the only multi-industry EFT trade group in the world.

The Association provides a forum for discussion of major business issues affecting the EFT industry, interacts with Congress and federal regulatory agencies, increases consumer awareness of EFT and sponsors EFT education programs for members. EFTA's annual EFT EXPO and Convention--with 140 exhibitors and 1,500 attendees--is one of the largest of its kind in the world.

EFTA's Councils and Committees meet throughout the year to discuss major developments in Retail Point of Sale, EFT Networks, Corporate Payments Systems, Videotex Financial Services, Government Relations, Consumer Affairs, Standards, Policy and Planning and the International Arena.

The Electronic Funds Transfer Association has 278 members, including large and small commercial banks, thrift institutions, credit unions, department stores, oil companies, data processing firms, equipment and software manufacturers, telecommunications companies and shared EFT networks.

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ELECTRONIC FUNDS TRANSFER ASSOCIATION

(February 11, 1986)

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Philadelphia National Bank
Philadelphia Savings Fund Society
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February 7, 1986

Hon. Slade Gorton, Chairman
Subcommittee on Financial Institutions
and Consumer Affairs
Committee on Banking, Housing and
Urban Affairs
United States Senate
534 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the Independent Bankers Association of America, I would like to submit the following comments on the two credit card bills which your subcommittee considered at a hearing on January 28, 1986. Those bills, S. 1922 and S. 1603, introduced by Senators D'Amato and Hawkins, respectively, would set national ceilings on interest rates charged by all credit card issuers.

The D'Amato bill would impose a ceiling at 4% above the rate imposed by the Internal Revenue Service on late payments by taxpayers (a compilation of prime interest rates over the preceding six months). At current market rates, this would translate to a 14% ceiling. In addition, the bill would amend the Truth in Lending Act to require all card issuers to disclose in initial card applications their annual percentage rate (APR) and any fees imposed for the issuance or use of their cards. The Hawkins bill, on the other hand, would simply provide for an APR ceiling of 5% above the average yield on 6-month T-bills.

The IBAA joins with the witnesses from the Federal Reserve, the American Bankers Association, the Washington Bankers Association, and the National Retail Merchants Association in strongly opposing these bills. Our Association has consistently opposed all attempts to set a national usury rate on consumer credit, including credit cards. Such legislation is not only unnecessary, but would be counterproductive, reducing the availability of credit cards for many consumers. It would also tend to reduce competition, since only large card issuers would have the resources to survive in such a restrictive environment. Finally, the bills would not achieve the desired result of lower credit charges to consumers.

The proponents of this legislation claim that credit card rates are too high relative to the "cost of funds" for credit card issuers and that there is essentially a conspiracy to keep rates at a uniformly high level of 18-21 percent. In response to these charges, it should be noted that credit card rates, like the prices of other products, vary widely and some issuers charge considerably more for their cards than others do. This is a good

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indication that the market is working--it does not need massive federal intervention.

We strongly disagree with the sponsors' use of the prime rate or the discount rate as a means of comparison with credit card rates to show that credit card rates are too high. As Federal Reserve studies have shown, such a comparison falsely suggests that there is a direct correlation between the prime rate or the discount rate and credit card rates. The Fed estimates that in 1984, the cost of banks' funds represented less than half of the total cost of providing credit card services. Other costs, such as advertising, telecommunication costs, processing, servicing, and losses due to fraud or the failure to pay, represent the majority of card issuers' costs. It is totally misleading to suggest that a sharp decline in the prime rate over the past 3 years should have led to an equally sharp decline in credit card rates; in fact, the spread between prime and the average credit card interest rate in 1977 was larger than the current spread.

The IBAA also disputes the contention that the credit card industry is not competitive. On the contrary, the industry is already fiercely competitive and becoming even more so. Over 15,000 institutions in this country now offer one or more major credit cards, yet no issuer controls over 11 percent of the total market. Senator D'Amato has pointed to a financial institution in Arkansas which offers very competitive rates. In the metropolitan D.C. area, a savings and loan has just begun advertising similar rates. These are no doubt only a few examples of the wide price differential we could identify for the Committee.

It is significant that this large and diffuse market is still expanding, with many new institutions entering the market. As you noted at this past week's hearing, the IBAA has recently launched a Visa/MasterCard program for its member banks. While it is true we have sought to provide this service to our members as a means of providing an additional profit source, our principal reason for starting the program was to help our members directly serve their customers, rather than allowing competing correspondent banks to "raid" their best customers. We are confident that bringing many more small banks into the market will serve to make it even more competitive. As was noted at the hearing, some of the lowest credit card rates in the country have been offered by small independent banks and we expect this to continue to be true.

Increased competition is also apparent from 1) the increased number of payment options now available to consumers, such as adjustable rates, lower annual fees, and no grace periods, and 2) the increased use of buyer incentives, such as discounts on purchases, travel insurance rebates, and other card-related enhancements. These recent developments suggest that consumers are indeed benefitting from lower credit charges, though not necessarily in the form of lower interest rates.

Increased competition within the industry and more value-added services are already resulting in a much greater consumer awareness of the availability of a wide range of options in the market. Due to increased issuer advertising and educational efforts by consumer groups, we see that consumers are beginning to seek out cards which best suit their individual needs and to shop around for the best offerings. This, too, is a positive development which will further increase competition.

The IBAA also objects to these bills because they would be counterproductive, in the sense that they would cut off credit to many borrowers, such as students and other persons with no previous credit history who find it hard to qualify for credit. A ceiling on interest rates would force card issuers, during periods of increased operating costs, to use the availability of credit as a means of reducing losses and increasing profits. Thus, an interest rate cap will not prove nearly as harmful to the card issuers as it will to those people who will be unable to qualify for any card at all.

We also object to federal legislation because it would preempt the laws in the 33 states which have usury limits on credit cards. The state trend, in fact, appears to be toward eliminating all interest ceilings. Whereas only 2 states had lifted rate ceilings by the mid-1970's, 16 states have now found that consumers are better served with no artificial limit.

Just as many states have found that usury limits on credit cards are difficult, if not impossible, to draft successfully, the D'Amato and Hawkins bills would simply not accomplish what they set out to do, namely, reduce consumers' borrowing costs. It is widely recognized that issuers can take a number of steps to recover the revenue lost through an interest rate cap. For example, they could eliminate the 25-33 day "float" period which approximately 30-40% of all credit card holders use to avoid paying any interest charges at all. Other alternatives would include increased annual fees or ancillary charges. Unless Congress wants to regulate every aspect of credit card pricing and servicing--including differentials for different types of issuers--then it is unrealistic to expect that a cap on interest rates will bring lower costs to consumers. In fact, these bills would actually constitute a fraud on the American public by leading people to believe that they would somehow be paying less to use their credit cards.

For these reasons, the IBAA urges you and the other members of the Banking Committee to oppose S. 1922, S. 1603, and all other attempts to legislate a mandatory national ceiling on credit card interest rates. If we can provide any other information or assistance to you on this issue, please let us know.

Sincerely,

B.F. Backlund
President

BFB/sid

cc: Members of the Senate Banking Committee

3-Year Treasury Securities
(Monthly Average Yields)
(Constant Maturities)[1]
1974-1984

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
January	6.96	7.23	6.99	6.22	7.61	9.50	10.88	13.01	14.64	9.64	10.93
February	6.76	6.65	7.06	6.44	7.67	9.29	12.84	13.65	14.73	9.91	11.05
March	7.35	6.81	7.13	6.47	7.70	9.38	14.05	13.51	14.13	9.84	11.59
April	8.05	7.76	6.84	6.31	7.85	9.43	12.02	14.09	14.18	9.76	11.98
May	8.27	7.39	7.27	6.55	8.07	9.42	9.44	15.08	13.77	9.66	12.75
June	8.15	7.17	7.32	6.39	8.30	8.95	8.91	14.29	14.48	10.32	13.18
July	8.41	7.72	7.12	6.51	8.54	8.94	9.27	15.15	14.00	10.90	13.08
August	8.66	8.16	6.86	6.79	8.33	9.14	10.63	16.00	12.62	11.30	12.50
September	8.41	8.29	6.66	6.84	8.41	9.69	11.57	16.22	12.03	11.07	12.34
October	8.00	7.81	6.24	7.19	8.62	10.95	12.01	15.50	10.62	10.87	11.85
November	7.61	7.46	6.09	7.22	9.04	11.18	13.31	13.11	9.98	10.96	10.90
December	7.24	7.43	5.68	7.30	9.33	10.71	13.65	13.66	9.88	11.13	10.56

[1] Yields on actively traded issues adjusted to constant maturities.

SOURCE: Federal Reserve Bulletin, Board of Governors of the Federal Reserve System.
G.13, Selected Interest Rates, Board of Governors of the Federal Reserve System.

Doc. No. 0688F - Eswar-Rao - 01/11/85

Statement of Visa U.S.A.
Submitted to the
Subcommittee On Financial Institutions And Consumer Affairs
Senate Banking Committee
United States Senate
On
S.1922 and S.1603
Legislation To Limit Credit Card Interest Rates
January 28, 1986

Visa U.S.A. Inc.("Visa") is pleased to submit the following statement on proposed legislation for federal limits on credit card interest rates.

Visa is a for-profit membership organization, incorporated under the laws of the State of Delaware, which administers the Visa card program within the United States. The membership of the corporation is comprised of more than 16,000 commercial banks, savings and loan associations, and credit unions which participate in the program by issuing cards bearing the Visa name and logo to customers, and signing up merchants to accept the cards. As of September 30, 1985, the Visa card was held by approximately 90 million individuals and accepted at more than 2.2 million merchant outlets and member and member offices throughout the country. For the four quarters ending June 30, 1985, the total dollar volume of the Visa system in the U.S. exceeded $68 billion. Accordingly, Visa has a significant interest in legislation proposing to establish limits on the rates of interest charged on credit card accounts.

Proponents of such legislation assert that such limitations are necessary since finance charges on credit card

accounts are, on the average, somewhat higher than rates applicable to other forms of consumer installment credit and commercial loans and are higher than open market interest rates such as the prime rate and Treasury bill rates. They further argue that, despite the numerous financial institutions issuing bank credit cards and the wide availability of credit cards issued by private card companies and retailers, there is no adequately functioning market for the establishment of credit card interest rates. Finally, there is an additional rationale which has been put forward recently for such limitations, that consumers have been accumulating more debt than they can handle due to vigorous marketing campaigns and low minimum charges on bank card accounts, and that rate controls are an appropriate response to combat this tendency.

We believe there exists no justification for such limitations, and we believe the basis assumptions upon which these proposals are premised are incorrect.

First, the proponents of controls point out that interest rates on federal funds and the prime rate have fallen over the past five years while interest rates on credit card loans have not. Hence, they conclude that there is no adequately functioning market mechanism for the establishment of interest rates on credit cards.

That credit card interest rates have not declined over the last four years in concert with open market rates is, in and of itself, an absolutely true statement. However, we respectfully

submit that as an analysis of the efficiency of the market, that statement alone is seriously deficient because it omits a number of significant facts.

The federal funds rate, prime rate, Treasury bill rates and negotiable certificate of deposit (above $100,000) rates all have one thing in common. They are not and never have been subject to state usury laws, federal price control laws or any other form of price regulation.

That is not today, and never has been true of credit card interest rates. For most of this century, consumer loan rates, including the maximum rates that can be charged on credit card balances, have been closely regulated by most states. The impact of that regulation was especially severe on the credit card industry during 1980 and 1981, the base years which proponents of controls use to generate statistics to prove their case.

In 1980 and 1981, most states had in effect usury laws so restrictive that they forced banks who wished to continue offering their customers credit cards to lend money out at a rate that was often lower than the bank's cost of funds or so close to the cost of funds that the spread was insufficient to cover the heavy administrative costs associated with credit card programs. The result was that the industry lost hundreds of millions of dollars a year on credit card portfolios. In 1980 our members lost an estimated $188 million on their Visa portfolios alone. In 1981 losses approximated $132 million. Comparable losses were incurred on MasterCard portfolios. The magnitude of these losses

and the expectation of future losses forced many financial institutions to terminate their credit card operations and most others to severely restrict the amount of credit they made available to consumers.

The fact of the matter is that during that period of time, the cost of funds was so high and inflation was driving administrative costs up so rapidly that, had the free market been allowed to work, financial institutions probably would have had to charge rates well in excess of 20 percent just to break even, or at most to realize a modest return on their credit card portfolios.

Had that been the case, we would have witnessed a situation in which interest rates on credit cards and other forms of consumer credit would have peaked along with other rates in 1981 and then begun a decline of six or seven percentage points to their current levels, just as we have seen declines in other interest rates.

But that was not the case. Banks were not allowed to charge a market rate on credit card finance. If one examines the evidence submitted by the Consumer Federation of America, the most striking fact is that in the 80-81 period, credit card interest rates averaged around 17.5 percent: this at a time when the prime rate was nudging 20 percent. No one at that time questioned whether there was an adequately functioning market mechanism for the establishment of credit card interest rates.

But the banks that had to leave the business and the

customers who were denied credit cards all understood that there was something wrong.

In the intervening years, banks sought and received legislative relief from these laws. (Most states still have usury laws, but their ceilings are much higher than they once were.) This enabled financial institutions in most states to raise rates to a level where they were able to begin to break even or actually show a reasonable return on their credit card portfolios. The fact that banks were able to begin to recapture their cost by charging annual fees and raising their finance charges also meant that the average rate charged on credit cards began to rise toward a market clearing level, which is where they are today.

A second major fallacy is the argument that for some unexplained reason, the market is not working. If this were true, it would be an extraordinary development in an economy as diverse and dynamic as ours. Further, one would imagine that the proper course of action would be first to attempt to diagnose the cause of this market failure before prescribing a remedy.

Apart from war or natural disaster, the usual reasons for the breakdown in a market are runaway inflation, the existence of price controls, or the impact of a monopoly, oligopoly or cartel. We can dismiss the first two without much discussion. The inflation rate is down substantially and such usury laws as do exist are for the most part not a constraint on pricing in the current environment.

That leaves the structure of the industry to examine. The industry is clearly not a monopoly or an oligopoly. Leaving aside the fact that the alternatives available for consumer lending encompass much more than solely credit cards, there are nearly 3,000 issuers of bank credit cards alone, not one of which has as much as 10 percent of the market, and another 13,000 participating financial institutions. A recent article in support of interest rate limitation legislation estimates that 10 of the top credit card issuers account for approximately 33% of the credit card balances outstanding, which under United States Department of Justice guidelines for measuring concentration in markets makes the credit card market an "unconcentrated" market by a mile. Clearly, there is no excessive concentration of economic power.

The issuers of credit cards for the most part are independent banks, some of whom issue cards only in a limited geographical area, and others who issue nationwide. Moreover, these financial institutions compete fiercely among themselves for deposits, loans and other financial services. It seems highly unlikely, therefore, that these same institutions would have either the inclination or the ability to form themselves into a cohesive cartel for the purpose of fixing prices on this one product alone and that this cartel could have survived with barely a defection for the last five years?

Cartels can survive only if they can adequately discipline their members and control entry of potential competitors. One

need only examine the current disarray in OPEC to see the evidence of that. It has never been charged or demonstrated by the proponents of controls that there is any functioning mechanism for doing either within the credit card industry.

Even if there were a group of bankers, and even if that group constituted a majority, who were interested in keeping their prices (finance charges) artificially high and they were able to somehow institute such a price, the system would quickly break down. The reason, as OPEC has learned, is that some of the participants would quickly realize that they could greatly increase their profits and gain a significant market advantage simply by cheating.

Hence, to believe that such a conspiracy exists one must also believe that there is not a single banker in the nation who is interested in maximizing his profits. And we don't believe any of the proponents of this legislation are saying that banks aren't interested in profits.

Proponents of legislation also claim that the credit card market is not free because consumers are presented with little choice. In fact, credit-worthy consumers are the object of quite numerous solicitations from issuers operating nationwide, regional and local card programs, each vigorously marketing the most attractive features of their highly competitive products. Consumers, moreover, are well-informed regarding credit card costs and features, according to studies commissioned by the Federal Reserve Board.

So then what's wrong with the market? We respectfully submit there is nothing wrong with the market. It is functioning exactly as free markets anywhere function. Basic economic theory teaches us that in a normally functioning market, supply and demand will work to establish a price at a point where the marginal cost of providing goods or services exactly equals marginal revenue. In dynamic markets, those relationships are constantly shifting either because of shifts in demand, technological change or the entry of new competitors.

We are seeing all of that occur in the credit card market today. A number of large banks have begun reducing finance charges in the hope that they can move market share. Whether they are correct or not only time will tell. In addition, new competition has entered the marketplace in the form of the Sears Discover card, cards issued by several oil companies and numerous retail cards.

The question may then be asked, why hasn't it happened sooner? Part of the answer, we submit, has been given above. Interest rates on credit cards were artificially low in the early 1980's and only by maintaining those rates has the industry been able to return to profitability over the past three years. Now that the industry is once again profitable, some issuers have perceived an opportunity to either increase market share by trimming rates or enter the market anew. This is exactly the kind of behavior one would expect in a normally functioning market.

It is ironic, therefore, that we should be discussing the reimposition of price controls at a time when price cutting and the entry of new competition is just beginning to emerge.

The question must be asked, what impact would such controls have on this emerging competition? If these controls have the same impact that price controls have always had on this and other markets, there is no reason to assume that they will do anything to increase competition. Just the opposite; they will certainly decrease competition and the availability of credit.

The other part of the answer to the question, why hasn't it happened sooner, is that credit card interest rates are very different from Treasury bill and large CD rates. Not only are the latter unregulated, but they are established by a very different mechanism. The T-bill, CD and similar rates are established in an open, auction market which reflects the collective impact of a great many forces, some of which are transitory in nature and others of which are more enduring. These forces are able to be transmitted and reflected very quickly through a very efficient market mechanism.

Furthermore, the rates cited by proponents of this legislation are not in fact the true cost of funds for bank card programs. The rates most often cited are current, short-term (90 day) rates. While it is true that this very short-term money is often included in the mix of funds that banks use to finance credit card receivables, it is not the only source. Banks use a variety of financing strategies to fund their receivables. These

strategies vary widely from bank to bank, but in most cases include a blend of very short-term money and longer-term debt. This is not to say that the overall cost of funds for bank card programs has not declined over the last several years; it has. However, the decline has not been as large as it has been for the short-term rates most frequently cited by proponents of this legislation. While short-term rates such as the prime rate and Treasury bill rates have declined by as much as 10 points over the last four years, the average cost of funds for banks in the Visa system has dropped only four or five points. Therefore, while proponents have claimed that banks' cost of funds is around 7%, banks themselves estimate the cost of funds to be between 10% and 11%, an estimate which finds support in a newly-emerging factoring market for credit card portfolios which reportedly is requiring a discount of greater than 10% to fund a credit card portfolio.

But credit card rates also reflect a significant number of other factors, including salaries and wages, the cost of operating a worldwide telecommunications network for the authorization and clearing of transactions, fraud and credit losses and other operating expenses. While the cost of funds has come down, most of these other costs have continued to rise, a factor that proponents of controls rarely take into account.

What that adds up to is a market that is admittedly less efficient than auction markets. But the same statement could also be made for the market mechanism that controls the vast bulk

of goods and services offered by American businesses to American consumers. There is always a time lag between the time the prices of raw materials decline (in this case the cost of funds) and the time that that decline is reflected in the prices of final products. For example, a one or two percent decline in the price of wheat is not immediately, and in fact may never be, reflected in the price of bread on grocers' shelves. Indeed, it is not uncommon for declines in raw materials to be more than offset by increases in prices of other factors of production.

This is an accepted fact of economic life and hence we hear no cry for the reimposition of price controls across a broad range of products simply because the market does not instantaneously reflect every nuance of every change in the cost of every factor that goes into making up final prices.

The third major fallacy is that the cost of funds to banks should be the sole criterion for determining the level of consumer interest rates. Certainly the cost of funds is an important element in determining final prices in the credit card industry; but it is not the only element, just as the cost of steel is not the only element that goes into the price of a car.

Even today, with the cost of funds lower than it has been in years, that expense item constitutes barely 50 percent of the total expenses incurred by financial institutions in connection with the operation of their credit card programs, according to a 1984 analysis by the Federal Reserve System. What has not been taken into consideration are the many unique expenses incurred in

connection with the operation and support of card systems, expenses which are not typically associated with other forms of credit. For example, each credit card system maintains a global telecommunications and data processing network. The Visa system alone, which responds to and records more than a million authorization messages and nearly five million clearing and settlement items each day, represent an investment of hundreds of millions of dollars. Comparable investments have been made by other credit card organizations. Participation in a credit card system also requires the maintenance by financial institutions of extensive telecommunications and data processing service facilities to support their operations or, in the alternative, procurement of those services from a third party.

Similarly, no consideration has been given to the significantly greater risks of fraud and credit loss assumed by financial institutions on the credit card. Unlike traditional installment credit which is generally secured and for which the risk of loss is easily estimated, the universal acceptability of the major credit card, together with inherent weaknesses of existing card authorization procedures, substantially increases the creditor's risk of credit and fraud losses. Although these risks will, in the future, be materially reduced through the development and installation of more point-of-sale terminals to authorize transactions and authenticate the identity of cardholders, such systems are still not sufficiently widespread to offer a significant level of protection. Implementation of

such systems will, of course, necessitate significant, additional investment on the part of card program participants.

Another fallacy inherent in the arguments made by the proponents of controls is the idea that the credit card and traditional installment credit are somehow the same, with similar operating characteristics. Quite apart from the significantly higher operating costs detailed above, the credit card possesses many unique characteristics which make it a more desirable form of credit extension for the average consumer.

When a consumer receives a card, he gets more than just an open-ended, unsecured line of credit from his bank. He gets a payment device which he can use to purchase goods and services at approximately 2 million merchant outlets and obtain cash at approximately 61,000 bank branches and ATM machines in the U.S. alone. Worldwide, the card is accepted as payment for goods and services at more than 4.5 million merchant outlets in more than 160 countries.

In addition, in virtually all instances, cardholders have the option of paying account balances within a grace period, typically 25-30 days, without incurring finance charges. Within the Visa system, over 30 percent of all cardholders pay account balances in full each month, representing more than 50 percent of Visa card transactions, without any accrual of finance charges. The claims of proponents of controls that financial institutions are assessing excessive finance charges fail to consider the effect upon card issuers of the "free period" and the significant

reduction in yield attributable to that failure. The actual yield to a bank offering a "free period" can be two to three hundred basis points less than if the "free period" was not offered.

The consumer, however, is well aware of the unique attributes of the card. Despite the availability of alternatives, each year since inception of the product, the number of cardholders has increased significantly, as has transaction volume. Within the Visa system, as of September 1985, cardholders totaled 90.0 million; up 15.7 percent from the previous year. Payment service dollar volume increased 21.8 percent.

Some proponents of interest rate legislation have expressed worry that this attraction of credit cards to consumers is unhealthy for consumers and dangerous for the economy, and that the interest rate limitations are necessary to counter this preference. The argument is that consumers are accumulating more debt than they can handle and are overheating the economy, and that interest rate reductions will alleviate the problem. It is indeed a curious economic argument that reducing the price of credit card loans will decrease the use of credit cards, but one that is true for a reason that the proponents of legislation do not want to acknowledge. It is true because artificially reducing credit card interest rates will reduce the supply of credit card credit available to consumers.

The underlying assumption that consumers are overburdened

with credit card debt is not supported by the facts. The percentage of consumers unable to pay the debts they accumulate remains tiny as a fraction of all consumer borrowing. The recent increase in credit losses in the credit card industry is a matter of concern in the banking industry, which will make appropriate adjustments in management of their card programs, as they did in the 1970s when a similar increase occurred. Concern over growth in consumer credit in the early 1960s and middle 1970s proved groundless then, and the evidence suggests it is groundless now. The increase in consumer indebtedness is in part based on neutral factors such as the demographics of the population in which a higher-than-normal proportion is in the stage of life where debt is used to establish households and acquire other necessities. The increase in debt in part also is based on positive economic factors such as the ability to support more debt due to increasing real income and increasing efficiencies in credit markets.

Given these factors driving the use of credit, the impact of reducing the supply of credit card credit, as interest rate limitations would do, will merely shift most consumer borrowing demand to different forms of credit, since there are many other sources of credit available to a consumer, albeit more costly and less convenient credit for those less credit-worthy consumers who will be unable to obtain credit cards if interest rate limitations are enacted. There will be some reduction in overall consumer borrowing, but not nearly as great a reduction as in

credit card borrowing. This conclusion is supported by the experience of states with interest rate limitations (usury controls). The effect of constricting the supply of controlled credit by interest rate controls was a growth in uncontrolled credit extended to consumers, with little effect on total borrowing. Therefore, proponents of credit card interest rate legislation are not only trying to fix something that isn't broken, they are hurting the consumer with the tool they want to use.

A variation of the "overburdened consumer" argument which has been argued by proponents of credit card interest rate limitations is that overzealous financial institutions have been issuing cards to uncredit-worthy consumers, thus driving up the institutions' costs through credit loss and, therefore, keeping the cost of credit to credit-worthy customers higher than is justified. In economic terms, this is not a reality. Financial institutions doing this would be acting against their economic self-interest, which is not realistic to assume. To begin with, the effect of issuing credit cards to consumers who will likely cause credit losses for the financial institution is to erode the financial institution's profit margin, which is not rational economic behavior. Understanding that a dollar saved on costs is a dollar of profits, it has been financial institutions which have raised most of the concern over poor credit risks, which evidences the industry's attention to costs of operating their credit card programs. Moreover, any problem of increasing credit

losses resulting from ineffective credit screening of credit card applicants will be corrected by the market. Competitors will adopt stricter credit criteria and accompanying lower interest rates in order to attract more credit-worthy customers from financial institutions which have higher interest rates because they have let credit losses get out of control.

This correction, incidentally, is the same result which interest rate control seeks to achieve. The difference is that in the scenario described above, the market will be finding its own level, whereas the proposed legislation would arbitrarily disrupt market forces, an approach which history has not shown to be very successful. The consumer is the ultimate judge of the fairness of credit card interest rates. If they are excessive, the consumer will look elsewhere for credit, or cut back on the use of credit.

The consumer obviously finds the credit card a useful and valuable tool in the conduct of his everyday business and personal financial affairs. This being the case, it is fair to attempt to assess the impact on both the consumer and the industry should any of the proposed bills before this committee become law.

We estimate that had these proposed interest rate limitations been in effect during the last five years, fully 50 percent of the receivables held in member bank portfolios would have lost money. In other words, Visa member banks holding 50 percent of the credit card receivables in the system would have

recorded losses for their programs. Since no business enterprise can tolerate losing money indefinitely, banks would have responded by cutting back on the number of credit cards available and limiting the amount of credit they were willing to extend.

And, judging by the value that consumer have placed on credit cards, it is difficult to imagine how anyone could argue that that would have been a pro-consumerist development.

We have cooperated with the American Bankers Association and MasterCard International in the preparation of a lengthy study by Lexecon Inc., which we are enclosing, which we believe represents a sound, reasoned analysis of the state of the industry and the seriously negative impact these legislative proposals will have on consumers.

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November 26, 1985

Senator Slade Gorton, Chairman
Senate Banking, Housing and Urban
Affairs Committee
Subcommittee: Financial Institutions and
Consumer Affairs
SD-534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Gorton:

We are writing you as counsel to Western States Bankcard Association (WSBA), a non-profit organization with a membership consisting of financial institutions located throughout the western states. WSBA is strongly opposed to proposed legislation before the Subcommittee for Financial Institutions and Consumer Affairs for federal limits on credit card interest rates. We urge you to vote against it if it is presented to your subcommittee. We also request that our comments be included as part of the official record for any future Senate hearings on this issue.

S.1603, introduced by Senator Hawkins, would limit the interest "which may be charged during a calendar year on an extension of credit obtained by use of a credit card" to five percentage points above the average investment yield on six-month treasury bills during the previous calendar year.

The impetus behind this legislative proposal has been media coverage of recent declines in financial indicators such as the "prime rate", without a concomitant decline in average credit card interest rates. This apparent anomaly has been attributed to excessive "profiteering" by credit card issuers. Allegedly, credit card issuers are reaping above-average profits from credit card operations at the expense of consumers.

While we understand the concerns giving rise to these proposals and allegations, WSBA strongly opposes the imposition of any type of ceiling on credit card interest rates. We are convinced that such proposals are, in the main, the result of misconceptions concerning both the nature

of the credit card market and the historical level of credit card rates. This letter is intended to explain why we respectfully disagree with the proposed legislation.

We believe that consideration of several points illustrates why legislative intervention to set a ceiling on credit card interest rates will not, in this instance, produce the desired result. First, our national experience demonstrates that credit is most fairly and efficiently allocated by market mechanisms unfettered by externally imposed restrictions. Second, the current market for credit card services is robust and highly competitive, and hardly reflective of the monopolistic situations generally associated with governmental intervention in market processes. Third, "credit card" lines of credit are fundamentally different from conventional commercial, mortgage, or installment loan lending products. Consequently, fluctuations in indicators such as the "prime" rate, the "discount" rate, and the three-month treasury bill rate are poor determinants of the appropriate level of credit card interest rates. Fourth, analysis indicates that banks and other credit card lenders are not reaping exorbitant profits on their credit card operations.

I. CREDIT IS MOST FAIRLY AND EFFICIENTLY ALLOCATED BY MARKET MECHANISMS.

The proposed legislation would impose national rate limitations on the amount of interest banks and other credit card issuers may charge consumers. Such a law would be an aberration in our society: it has as its function the control of the price of a commodity consumed by the public. Although our national history contains other examples of price controls, generally they have failed to work because their cost to society has proved greater than their benefit. Such is the case with usury limits.

As a general proposition, based on strongly held and well-developed political and social views, the American economy has long been characterized by the free market operating without government interference, except when clear economic or social justification can be shown for that intervention.

Consequently, artificial price controls of whatever character traditionally have been rejected as being unacceptable mechanisms for allocating or pricing goods and services. As a form of price control, usury limits fare no better under contemporary analysis. It cannot be overemphasized that usury laws are nothing more than price controls that impose specific limitations on the price (reflected as interest)

paid for a specific commodity (the use of money). As with all such artificial governmental controls, our American experience has indicated that they are simply inefficient and unfair and produce inappropriate social and economic dislocations. Inefficiency and unfairness result because lenders and other creditors are unable to charge prices for credit services that are commensurate with their costs. Since the entities, in order to survive, must operate at a profit, any unprofitable transactions must be subsidized through rates charged to other customers. As a result, the cost to some borrowers is too low, while that to others is too high.

Secondly, to reduce losses, and therefore costs, creditors in a rate-controlled environment are forced to limit access to only low-credit-risk consumers.

There may be some few instances in which price controls have any justification in a society that highly values individual choice. However, governmental intervention of the type represented by the proposed legislation should legitimately be called for only where a market assumes monopolistic characteristics and competition ceases to operate. As our discussion below indicates, such circumstances are clearly absent from the current credit card market in the United States.

II. THE CURRENT MARKET FOR CREDIT CARD SERVICES IN THE UNITED STATES IS HIGHLY COMPETITIVE.

Imposition of a federal ceiling on credit card interest rates would be a useful measure only if there were significant evidence of a widespread lack of competition between banks and other credit card issuers in providing credit services to the American public. Such an environment certainly does not exist in the United States at present. Indeed, more than 15,000 financial institutions currently provide some type of credit card program. These services are generated by a broad cross-section of corporate institutions: commercial banks, retail stores, credit unions, savings and loan associations, finance companies and others all have actively participated in the credit card market in recent years. A number of competing bank and retail credit cards are now available in every market area. This large number of suppliers in the market is a clear indication of the existence of robust competition. Under such circumstances, no credit card issuer, or group of issuers, can maintain a position of monopoly power and charge a monopoly profit.

Moreover, the entrance of numerous additional competitors into the credit card field such as Sears (with its new nationwide Discover card), Shell, and Household

International is evidence that the current credit card market is a dynamic, constantly changing arena where numerous institutions are competing for a finite number of customers. In order to attract consumers, card issuers are currently engaging in aggressive marketing strategies, searching for new accounts through solicitations which are not only local, but also national in scope. They offer numerous, differing and attractive pricing options for consumers. The current level of credit card interest rates, then, clearly is attributable to factors other than lack of market competition.

III. CURRENT CREDIT CARD INTEREST RATES ARE REFLECTIVE OF THE VALUABLE SERVICES PROVIDED BY CREDIT CARD ISSUERS.

The extension of credit through credit card mechanisms is a relatively recent phenomenon. It is a service that has generated enormous positive benefits for both our credit markets and the average American consumer. For consumers, credit cards are a simple, convenient and efficient means of payment and credit access.

A. Services Provided to Consumers.

Credit card plans provide qualified consumers with an unsecured, revolving line of credit recognized by, and usable at, tens of thousands of merchants and financial institutions worldwide. Terms of repayment are flexible and at the discretion of the cardholder. A consumer carrying a bank credit card, for example, can make a series of purchases of goods and services at different locations during a month and then receive and pay a single bill on which each seller is identified. This payment mechanism is safe, since federal laws limit losses to the consumer from a lost or stolen credit card to $50. Increasingly, credit cards also provide consumers with quick and easy access to cash 24 hours a day, seven days a week through a nationwide network of automated teller machines. Moreover, credit cards are invaluable as identification for check cashing, hotel registration, car rentals, and other important services. These worldwide, conveniently available services involve complex, sophisticated operational and legal arrangements that were costly to create and are costly to maintain.

These services and protections are provided to credit card consumers whether the charge card is used as a payment or a credit mechanism. At present, almost all credit card plans charge interest only if card holders pay less than the full amount billed during the period. Thus the credit card holder determines whether, and to what extent, the credit feature of the card service is employed. Currently

almost half of all credit card users pay off their entire account balance when billed. These cardholders therefore receive -- at no direct cost -- as much as 40 to 50 days of free credit from the date of purchase to the date the payment must be made, while providing no finance charges to offset the costs of establishing and maintaining their accounts. Because of the existence of this payment "grace period," the effective annual rate of interest charged to credit card holders who incur a finance charge is considerably less than the advertised or disclosed annual percentage rate.

This concept is best illustrated through an example. Assume a 30-day billing period ending on the last day of each month. If X, a credit card holder, uses his credit card on January 5th to make a $100 purchase, under the terms of most credit card arrangements, X would receive an interest-free 25-day grace period from January 5th until January 30 before his purchase is billed on his credit card statement. Once this charge is billed, X may also receive another 20 to 25-day grace period before his payment for the purchase is due. If X decides to pay his account balance in full before the payment due date, he/she has received a 45 to 50-day interest-free loan of $100.

The effect of these interest-free loans on the returns to card issuers from their operations and on real costs to consumers is significant. Studies done by the Credit Research Center at Purdue University indicate that the actual yield to creditors from their credit card operations is significantly less than the APR required to be disclosed to consumers under federal law. Sample surveys indicate that effective yields for retailers are only 84% of disclosed APR's. Similarly, effective yields for banks represent only 83% of quoted rates. Consequently, if the disclosed rate on a bank card is 18% the actual yield to an average bank would equal approximately 14.94%. Another way of expressing this same phenomenon is that the average real price of credit to that bank's customers as a group is also 14.94%. This reality should be an important component of any discussion or consideration of the issue of credit card rates. To reach a policy resolution based on the rates disclosed is to base policy on a badly distorted economic analysis.

This interest-free loan period, as well as the numerous other costly convenience features noted above, is unique to the credit card market, and indicative of the valuable services efficiently provided to consumers by the credit card industry. It makes facile comparisons of rates available in other forms of credit quite inappropriate.

B. Costs of Credit Card Services to Issuers.

Credit card services are provided to American consumers at a high cost to our credit card industry. Over the past 10 years, the cost of funds has represented only approximately 30% of total credit card costs for bank issuers. This amount contrasts sharply with comparable cost-of-funds figures for other types of lending by banks, such as mortgage lending and commercial lending, as to which the costs of funds as a percent of total costs equals 90% and 75%, respectively. These additional non-financing costs, unique to the highly competitive credit card market, are the result, in part, of the industry's continuing investment in a massive telecommunications and labor infrastructure in order to provide consumers with safe and secure credit card access.

Distinctions between credit card and other types of credit plans are apparent even in the application stage. Verifying the creditworthiness of a large volume of applicants, approving applications and issuing cards requires credit card issuers to maintain a highly skilled labor force trained to expedite this process in order to swiftly respond to consumer needs.

Similarly, there are significant transaction costs associated with consumer use of credit cards at the point of sale. Participating merchants must, in most cases, seek authorization from the card issuer in order to complete the transaction. Increasingly, authorization is provided to the merchant through electronic means. While this procedure improves drastically card and system security, investment in such technology continues to be costly for the credit card industry.

Additional telecommunications expenditures are required to transmit sales data from merchants, who normally deposit their receipts in local banks, to the card-issuing bank, which in many cases is in a different region of the country. In like manner, the payment process, in which thousands of billing statements are forwarded to consumers periodically, requires specialized equipment. And, pursuant to federal law, additional personnel are needed for maintaining procedures to resolve quickly alleged errors in billing statements.

These costly expenditures produce an efficient and convenient credit card system. Unfortunately, these measures increasingly must be supplemented with efforts to curb the high costs of credit card fraud and counterfeiting. Fraud losses are alarmingly high, although the industry is doing all it can to contain fraudulent activity. For example, in

1973, total fraud losses for MasterCard members were $2,700,000. By 1984, that figure had escalated to over $78,000,000. The burgeoning incidence of organized credit card fraud (especially regarding counterfeit cards) in recent years has added significantly to the cost of providing the card service. The card industry is developing various security measures to help alleviate the problem of fraud. Some of these new security measures include holograms, perforated or carbonless sales slips, lower floor limits for some merchants, and on-line authorizations for all transactions. All of these new security measures add significantly to a card issuer's operating costs.

In discussing these costs issues, it is our purpose merely to emphasize that these costs are real and continuing obligations which competitors in this industry must fulfill in order to adequately serve the consuming public. Again, these costs are unique to the credit card industry because the convenience the industry provides is exceptional and the costs are reflected in the current rate of interest charged to card customers.

IV. BANKS AND OTHER CREDIT CARD ISSUERS ARE NOT MAKING EXCESSIVE PROFITS ON THEIR CREDIT CARD OPERATIONS.

Proponents of the legislation directed at rate limitations have argued that credit card issuers are currently reaping "excessive" profits on their card operations. An analysis of the credit card market indicates that this is simply not the case.

Historically, there has been relatively little vacillation in the annual percentage rate charged by issuers on their credit cards. During the period 1972-1984, APR's on credit cards fluctuated between 16.5 and 19.0%. This relative stability in credit card interest rates may be attributed to two major factors: (1) the relatively small impact of the cost of funds in the overall cost equation for credit cards; and (2) the distortive effect of statutorily imposed state ceilings on interest rates.

Over this same period, average before-tax earnings for credit card operations have been significantly lower than for commercial or mortgage lending. During the late 1970's and early 1980's, with financing costs at unprecedented high levels, credit card issuers were unable to raise card rates to reflect their true cost of funds because of state-imposed usury ceilings. The result was a period of extremely low or negative profit margins on credit card activities and a restriction on credit available in some jurisdictions. Many

banks and other credit card issuers nevertheless maintained the rather unprofitable product line through difficult times, while seeking legislative relief from state interest rate caps.

The existence of these rate caps created unnecessary hardships for American consumers during the period 1979-1982. In order to maintain marginal profitability, credit card issuers were forced to cut costs through such measures as charging annual fees for card accounts, tightening lending standards, and shifting their focus from the credit card business to other, more profitable lending activities. Consumers, particularly those seeking credit for the first time, thus were affected adversely by artificial constraints placed on the credit card industry.

With their credit card activities regaining an acceptable level of profitability, card issuers have been able aggressively to pursue new business, thereby expanding greatly the amount of credit available to consumers. In the present regulatory environment, this has proved a prudent short-term response to changing economic conditions. Federal disclosure legislation requires customer notification 15 days prior to the effective date of any rate increase. Many states impose more extensive notice requirements. Given the shadow cast over financing rates by the immense federal budget deficits, credit card issuers understandably are skeptical whether current favorable conditions will persist. Some money-center banks, such as Manufacturers Hanover and Bank of New York, have moved to lower significantly the APR's on their accounts. It is probable that as long-term economic prospects become more certain, other credit card issuers will also lower their rates somewhat.

It is important also to note that banks also have responded to changing economic circumstances in ways not reflected in credit card interest rate shifts. For example, banks are now making available to their card customers from independent vendors new services such as legal advice; common carrier travel accident insurance; automobile clubs; discounts on airfares and car rentals and hotel accommodations; and discounts on merchandise purchased through a credit card. The value of these services is considerable. It represents a better card product at the same price, the economic equivalent of a price reduction.

Hence, there have been market adjustments to lowered cost of funds. However, considering the enormous non-financing costs associated with the industry, the unsecured nature of the credit extended, and the uncertainty of the present economic environment, current credit card

interest rate levels reflect a realistic determination by card issuers of the costs associated with their product. The rates of return are by no means excessive.

V. CONCLUSION

The proposed legislation on interest rate caps deviates significantly from our national tradition of refraining from interference with market mechanisms unless substantial economic justification exist for imposing restrictions. We believe strongly that no such justifications exist in regard to the domestic credit card industry at present. The market is robust and dynamic, and continues to provide convenient and efficient service to consumers at a price reflecting industry costs. The continuing growth of the industry indicates that, on balance, the value of the services offered by the card industry is appropriately reflected in the rates currently prevalent in the industry. Moreover, the market has continued to respond to changing economic circumstances in ways not adequately represented in credit card interest rate shifts. Usury legislation would have a disruptive effect on industry flexibility in these uncertain economic times. It might not only cripple the card industry, but also harm the American consumer. We urge you to oppose S. 1603.

Respectfully yours,

Roland E. Brandel

cc: Senator Jake Garn
Senator Chic Hecht
Senator Phil Gramm
Senator Alfonse M. D'Amato
Senator Paul S. Sarbanes
Senator William Proxmire
Senator Alan Cranston
Senator Christopher J. Dodd

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